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ADVOCATE

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TO CONGRESS

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**THE IRS'S USE OF NOTICES OF
FEDERAL TAX LIEN (NFTL)**

The IRS’s Use of Notices of Federal Tax Lien (NFTL)

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The IRS's Use of Notices of Federal Tax Lien (NFTL)

Executive Summary

A Notice of Federal Tax Lien (NFTL) is a legal tool the IRS uses to facilitate the collection of unpaid tax debts. The NFTL places the public on notice that the IRS has a legal claim to taxpayers' property as security or payment for their tax debt. The IRS frequently files liens using a systematic process that does not take into account the individual circumstances of the taxpayer (*e.g.*, the taxpayer may have an economic hardship, and the filing of the lien may actually be detrimental to the collection of the liability).

The IRS issued nearly one million liens in fiscal year (FY) 2009.¹ This was an increase of 85 percent from the number of liens filed in FY 2005 and about 475 percent from FY 1999.² By comparison, the number of balance due individual returns (Forms 1040) filed from FY 2005 to FY 2009 rose only 24 percent.³ For FY 2009, liens made up over 4,000 of the cases worked by TAS, placing this inventory category in the top one-third of TAS receipts.⁴ The National Taxpayer Advocate is concerned that the IRS's use of the NFTL is harming taxpayers, especially those with economic hardships, while not significantly enhancing the IRS's ability to collect delinquent liabilities.⁵

The TAS Research & Analysis staff analyzed data from taxpayers with liabilities in tax year (TY) 2002.⁶ As part of this study, TAS Research reviewed nearly 1.9 million transactions (payments credited to taxpayers' accounts using transaction codes) involving over 270,000 taxpayers who incurred delinquent TY 2002 liabilities.⁷ The 270,000 taxpayers studied did not have any outstanding tax liabilities at the time their TY 2002 delinquency arose. TAS Research & Analysis examined the subsequent payment history of these taxpayers, along with how the IRS recorded their payments, to explore the relationship between revenue collection and the use of the NFTL. The research objectives for this project included:

- How often is the NFTL effective in securing payment on the tax debt?
- What amounts of the tax payments are not attributable to the NFTL?
- Does increasing the number of tax liens filed increase tax revenue?
- What percentage of NFTLs is filed systemically?

¹ IRS, Collection Activity Report, NO-5000-C23, *Collection Workload Indicators Reports* (Oct. 13, 2009). In FY 2009, the IRS filed 965,618 NFTLs.

² IRS, *IRS Data Books, Table 16, Delinquent Collection Activities, 1999-2008*; IRS, Collection Activity Report, NO-5000-C23, *Collection Workload Indicators Reports* (Oct. 13, 2009). The IRS filed about 168,000 liens in FY 1999 and 522,887 in FY 2005.

³ IRS, *IRS Data Book, Table 16*. Balance due returns (Forms 1040) rose from 22,982,544 in FY 2005 to 28,465,648 in FY 2008.

⁴ Taxpayer Advocate Management Information System (TAMIS) database. Total TAMIS receipts for FY 2009 were 4,232 from all Primary Core Issue Codes (PCICs) associated with liens.

⁵ IRS use of the NFTL damages taxpayers' credit rating, harms their ability to meet future liabilities, and may even have a negative impact on tax collection. See Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*, Vol. I, *supra*.

⁶ We chose tax year 2002 to allow a sufficient time interval to elapse to analyze subsequent payments.

⁷ Specifically, we found 270,399 taxpayers with NFTLs filed on their TY 2002 liability. Please see the methodology section for a more detailed description of the study parameters.

The IRS's Use of Notices of Federal Tax Lien (NFTL)

- How many NFTLs are filed against taxpayers who are incurring a hardship?

The IRS designated payment codes (DPC) for more than half of all the payments made by these taxpayers were insufficient to determine the source of the payment.⁸ Consequently, less than half of the delinquent payments definitively identified the payment source. Ultimately, nearly \$905 million of payments from these taxpayers were traceable.⁹ Given the traceable payment sources, we found:

- Payments associated with liens amount to less than \$1 out of every \$5 of payments.
- Payments that came from sources other than liens accounted for over \$4 out of every \$5 the IRS collected.

We also found that the IRS has continued to increase the number of NFTLs filed, but that there has not been any real increase in dollars collected (*i.e.*, the total collection yield):¹⁰

- The IRS increased the number of liens filed by 475 percent between FY 1999-2009.¹¹
- During FY 1999-2009, when adjusted for inflation, the total dollars IRS collected actually declined by seven percent from \$29.4 billion to \$27.2 billion (in terms of real dollars valued as of 2009).¹²

The IRS generates a majority of its liens through its Automated Collection System (ACS).¹³ Just under two-thirds of the liens requested by ACS were made systemically (*i.e.*, the IRS generates these liens without determining whether the taxpayers have any assets, or are likely to acquire any assets to which the NFTL would attach).¹⁴ As an example, NFTLs are automatically requested for every taxpayer whose delinquency exceeds \$5,000 when the IRS determines that the liability is Currently Not Collectible (CNC). The CNC designation includes situations where the IRS has determined that the collection of the liability would create a hardship on taxpayers by leaving them unable to meet necessary living expenses. For taxpayers with accounts in CNC status due to economic hardship, we found:

⁸ Of the 1,886,683 total payment transactions, only 629,158 transactions had the Designated Payment Code (DPC) code assigned. 1,257,525 transactions were coded "miscellaneous" or "DPC indicator not present" or had no DPC coding. Of the 1,257,525 transactions, 283,091 had a refund offset transaction code; leaving 974,434 payments (or 51.6 percent) as unaccountable. Thus, 912,249 payments (or 48.4 percent) had meaningful DPCs or could be identified as refund offsets.

⁹ About \$895 million of payments were not traceable.

¹⁰ The total collection yield is any revenue collected attributable to IRS collection activities, such as levies, liens, and seizures. Total collection yield in a fiscal year includes tax, interest, and penalties from multiple tax years.

¹¹ IRS, *IRS Data Books, Table 16, Delinquent Collection Activities, 1999-2008*; IRS, *Collection Activity Report, NO-5000-C23, Collection Workload Indicators Reports* (Oct. 13, 2009). In FY 2009, the IRS filed 965,618 NFTLs.

¹² Bureau of Labor Statistics, Dept. of Labor, *Consumer Price Index - All Urban Consumers (CPI-U)*, at <http://www.bls.gov/CPI/> (last visited Oct. 10, 2009).

¹³ IRS, *Collection Activity Report, NO-5000-C23, Collection Workload Indicators Reports* (Oct. 13, 2009). Of the 965,618 NFTLs filed in FY 2009, 491,822 (50.9 percent) were filed by the ACS.

¹⁴ ACS, *Customer Service Activity Reports (CSAR), FY 2009 BOD report*. See also IRS response to TAS Research & Analysis request (Oct. 30, 2009). ACS systemic programming retrieves cases with expired follow-ups in R7 status (accounts with a 25-day follow-up where the system generated an LT39, *Reminder Notice*), determines if the aggregate assessed balance is greater than \$5,000, and whether there are any modules without a lien. If all three criteria are met, the system requests the lien by inputting history code FM10 on the account. E-mail from IRS subject matter expert (Nov. 2, 2009). See also Internal Revenue Manual (IRM) 5.19.5.3.7, *Reminder Notices* (Dec. 1, 2007); IRM 5.19.5.5.7, *R7 - Lien Determinations (Follow-Up to LT39)* (May 29, 2008).

The IRS's Use of Notices of Federal Tax Lien (NFTL)

- IRS refund offsets were responsible for nearly \$6 out of every \$10 in payments collected from taxpayers.
- NFTLs were responsible for \$2 out of every \$10 in payments collected from taxpayers.

Given the aforementioned findings, we recommend:

- The IRS should discontinue the policy of automatic NFTL filing on CNC hardship accounts with an unpaid balance of \$5,000 or more.
- The IRS should base lien filing determinations for all IRS contact employees on a thorough review of all the taxpayer's circumstances (including the existence and the value of assets, the taxpayer's financial information, the existence and amount of non-tax debt, and the ramifications of the lien on the taxpayer's credit rating).
- The IRS should institute a quality review of payment coding used to track taxpayers' payments for tax liabilities. An accurate method of tracking payments is an essential first step in determining the impact of various collection tools on taxpayers and the efficacy of their use.
- The IRS should study whether lien payments from CNC hardship taxpayers impose an economic hardship on these taxpayers.

Introduction

A Notice of Federal Tax Lien is a legal tool the IRS uses to facilitate the collection of unpaid tax debts. This tool gives IRS priority to assets over other creditors in certain circumstances. In fiscal year 2009, the IRS issued nearly one million liens, an increase of about 475 percent from FY 1999.¹⁵ Given the widespread use of this collection tool, it is important for the IRS to understand the taxpayers' individual circumstances and financial situation prior to filing the NFTL. The National Taxpayer Advocate is concerned that the IRS's use of the NFTL may be harming taxpayers, especially those with economic hardships, while not significantly enhancing the IRS's ability to collect delinquent liabilities. Moreover, taxpayers with damaged credit ratings will have more difficulty meeting future liabilities and might therefore have increased subsequent noncompliance.

Given these concerns and the increasing number of liens filed, the National Taxpayer Advocate tasked TAS Research & Analysis to study NFTLs and their role in tax administration. After careful consideration, we decided that the best way to accomplish this task was to review the payment history of taxpayers who had a lien "attached" to them. We ultimately selected over 270,000 taxpayers newly noncompliant because of their Tax Year (TY) 2002 liabilities and tracked their payment history. We will discuss the selection of these taxpayers in more detail in the methodology section.

Objectives

The objectives for the research project are as follows (the measure(s) accompanying the objectives are in parentheses):

- How often is the NFTL effective in securing payment on the tax debt? (Measure is the tax payments resulting from the NFTL divided by total payments).
- What amounts of the tax payments are not attributable to the NFTL? (Measure is the tax payments from all sources other than the NFTL divided by total payments).
- Does increasing the number of tax liens filed increase tax revenue? (Measure is the increase in filed NFTLs versus the total payments secured from all collection activities (in real 2009 dollars)).
- What percentage of NFTLs are filed systemically? (Measure is total number of NFTLs filed systemically divided by all NFTLs).
- How many NFTLs are filed against taxpayers who are incurring a financial hardship? (Measure is percent of NFTLs filed against taxpayers with financial hardship divided by total number of NFTLs).

¹⁵ IRS, *IRS Data Books, Table 16, Delinquent Collection Activities, 1999-2008*; IRS, *Collection Activity Report, NO-5000-C23, Collection Workload Indicators Reports* (Oct. 13, 2009). In FY 2009, the IRS filed 965,618 NFTLs.

The IRS's Use of Notices of Federal Tax Lien (NFTL)

BACKGROUND**What is a Lien?**

A federal tax lien (FTL) arises when the IRS assesses a tax liability, sends the taxpayer notice and demand for payment, and the taxpayer does not fully pay the debt within ten days.¹⁶ An FTL is effective as of the date of assessment and attaches to all of the taxpayer's property and rights to property, whether real or personal, including those acquired by the taxpayer after that date.¹⁷ This lien remains until the liability is either fully paid or is legally unenforceable.¹⁸ This statutory lien is sometimes called the "secret" lien, because third parties – and usually the taxpayer – have no knowledge of the existence of this lien or the underlying tax debt. Further, the taxpayer may not understand the significance of this statutory lien.¹⁹ To put third parties on notice and establish the priority of the government's interest in a taxpayer's property against subsequent purchasers, secured creditors, and junior lien holders, the IRS must file an NFTL in the appropriate location, such as a county registrar of deeds.²⁰

Accordingly, an NFTL is a legal tool that enables the IRS to collect tax debts not paid by taxpayers. NFTLs place other creditors on notice of the existence of a tax delinquency and bolster the IRS's claim to an interest in taxpayers' property as security or payment for their tax debt. An NFTL may be filed only after certain requirements are met.²¹ Once these requirements are met, an NFTL is filed for the amount of the tax debt. By filing notice of this lien, the taxpayers' creditors are publicly notified that the IRS has a claim against all of their property, including property they acquire after the lien is filed. This notice is used by courts to establish priority in certain situations, such as bankruptcy proceedings or sales of real estate.

An NFTL "attaches" to all of the taxpayers' property (*e.g.*, their house or car) and to all of their rights to property (such as their accounts receivable if they are running a business). Once a lien is filed, the taxpayer's credit rating may be harmed. For example, the taxpayer may not be able to get a loan to buy a house or a car, get a new credit card, or sign a lease.²² Therefore, it is very important that the IRS properly evaluates the taxpayer's situation and properly uses the lien as one of its collection tools. The IRS frequently requests NFTLs using a systematic process that does not take into account the taxpayer's individual cir-

¹⁶ IRC §§ 6321 and 6322. IRC § 6201 authorizes the IRS to assess all taxes owed. IRC § 6303 provides that within 60 days of the assessment the IRS must provide notice and demand for payment to any taxpayer liable for an unpaid tax.

¹⁷ See IRC § 6321; IRM 5.12.2.2 (May 20, 2005).

¹⁸ IRC § 6322.

¹⁹ IRC § 6321. The IRM refers to this statutory lien as a "silent" lien. See IRM 5.12.2.2 (May 20, 2005).

²⁰ IRC § 6323(f); Treas. Reg. § 301.6323(f)-1; IRM 5.12.2.8 (Oct. 30, 2009).

²¹ The IRS must first assess the liability. The IRS will then send the taxpayer a Notice and Demand for Payment, which is a bill that tells how much is owed in taxes. Next, the taxpayer must neglect or refuse to fully pay the bill (debt) within 10 days after notification. In addition, the IRS exercises its administrative discretion by only filing a lien if the tax debt exceeds a certain dollar threshold.

²² See Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*, Vol. I, *supra*.

The IRS's Use of Notices of Federal Tax Lien (NFTL)

cumstances (e.g., the taxpayer might have an economic hardship).²³ The National Taxpayer Advocate is concerned that the systematic application of liens is unnecessarily harming taxpayers, especially those with economic hardships.

Growth in Lien Filings and Impact on Taxpayers Who Require Assistance from TAS

The IRS issued nearly one million liens in FY 2009. This was an increase of about 85 percent from the number of liens filed in FY 2005.²⁴ By comparison, the number of balance due individual returns (Forms 1040) filed during this same period rose 24 percent.²⁵ For FY 2009, lien related issues made up over 4,000 of the cases worked by TAS, in addition to cases where the lien was a secondary issue or where other collection issues were involved including the filing of an NFTL.²⁶

Taxpayers with Tax Debts and Liens Filed by IRS

TAS Research & Analysis staff analyzed data from taxpayers with liabilities in TY 2002.²⁷ As part of this study, TAS Research reviewed nearly 1.9 million transactions (payments credited to taxpayers' accounts using transaction codes) involving over 270,000 taxpayers who incurred delinquent tax liabilities.²⁸ The 270,000 taxpayers studied did not have any outstanding tax liabilities at the time that their TY2002 delinquency arose. TAS Research & Analysis examined the subsequent payment history of these taxpayers, along with how the IRS recorded their payments, to explore the relationship between revenue collection and the use of the NFTL. The findings from this research are discussed below.

METHODOLOGY

Our principal objective was to look at a segment of taxpayers with Notices of Federal Tax Lien, examine their payment transactions, and determine whether the payment was attributable to the lien. We selected TY 2002 modules with NFTLs, so that we could track their subsequent payment history over several years. We selected only modules that became newly delinquent in TY2002. In addition, if there were prior tax modules in collection status, these modules had been satisfied prior to the origination of the TY 2002 liability. This approach ensured that the payments were not associated with prior accounts.

The data set was built in three steps. The first step was to determine new collection accounts in TY 2002. The second step was to eliminate those with prior collection accounts still open. The third step was to determine if there was an NFTL, and if so, to

²³ The IRS ACS files liens systemically in over six out of every ten cases where a lien is filed.

²⁴ IRS, *IRS Data Books, Table 16, FY 2005* (522,887). IRS, *Collection Activity Report, NO-5000-C23, Collection Workload Indicators Reports* (Oct. 13, 2009). The IRS filed 522,887 NFTLs in FY 2005 and 965,618 NFTLs in FY 2009.

²⁵ IRS, *IRS Data Books, Table 16, FY 2005 and FY 2008*. Balance due returns (Forms 1040) rose from 22,982,544 in FY 2005 to 28,465,648 in FY 2008.

²⁶ Taxpayer Advocate Management Information System (TAMIS) database. Total TAMIS receipts for FY 2009 were 4,232 from all PCICs associated with liens.

²⁷ We chose TY 2002 to allow a sufficient time interval to elapse to analyze subsequent payments.

²⁸ Specifically, we found 270,399 taxpayers with NFTLs filed on their TY 2002 liabilities. See the methodology section for a more detailed description of the study parameters.

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attach payment transaction codes, dates, and amounts to the data. Using the Compliance Data Warehouse (CDW) Accounts Receivable Dollar Inventory (ARDI,) and the Individual Master File (IMF) Module file, we extracted TY 2002 modules that became newly delinquent as designated by the record type. Taxpayers that had previous collection accounts still open were removed from the data set. The NFTL date (Transaction Code (TC) 582 date) was added to the file, as were all payment and offset transaction codes, transaction dates, transaction amounts, and DPCs for the corresponding tax year from the CDW IMF Transaction History file. At the time, the latest IMF Transaction History extract cycle was 200913 (13th week of 2009). We added CNC designations with hardship status to the file using TC 530 (CNC), TC 537 (CNC Reversal), and the TC 53X closing codes (to determine hardship) from the CDW IMF Transaction History File. We added other variables such as total positive income (TPI)²⁹ and adjusted gross income from the CDW Individual Returns Transaction File (IRTF).

The resulting file contained 1,886,683 payment transactions associated to 270,399 TY 2002 tax modules or taxpayers (there was a one-to-one correspondence between tax modules and taxpayers). Payment (type) transaction codes along with their associated designated payment codes were used to determine whether a payment was attributable to the lien, not attributable the lien, or attributable to an offset. We used the payment transaction code to identify offsets, and the DPC to determine whether other payments (*i.e.*, payments that were not offsets) were attributable to the lien. The transaction codes used are contained in Appendix 1. Appendix 2 contains a list of the DPCs and associated information including whether the code is associated with payments attributable to liens.

We found, however, that about 1.3 million of the nearly 1.9 million payment transactions, about 67 percent, had a DPC of either a 00 (*i.e.*, “unspecified”), or a 99 (*i.e.*, “miscellaneous”), or that the DPC was missing.³⁰ Since these payments were the majority of the payment transactions and we could not exactly determine if these payments were attributable or not attributable to the lien, we removed them from the data analysis. Payments associated with offset transactions remained in the data set.

There were 20 payments with unrecognized designated payment codes, of which six payments were considered attributable to the lien, 13 payments were considered attributable to an offset, and one payment was considered not attributable to the lien. Our final payment data set had 912,249 payment transactions associated to 159,161 taxpayers.

²⁹ TPI is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distributions from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as zero.

³⁰ 1,257,525 of the 1,886,683 payment transactions had either a DPC of 00 or 99, or no DPC.

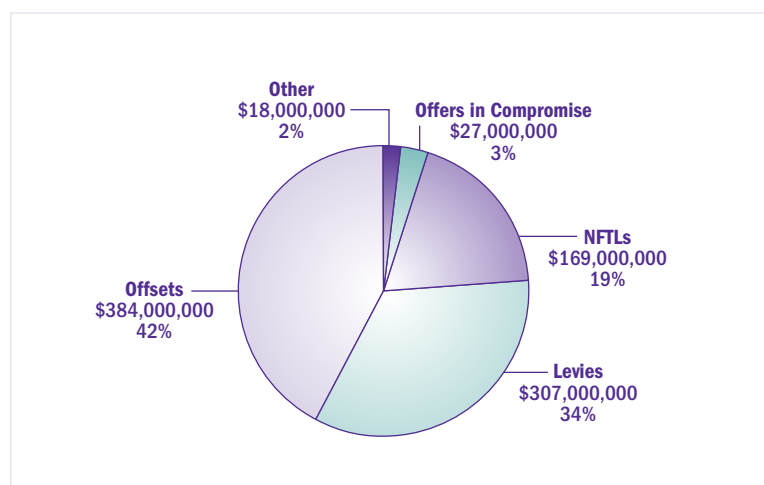
The IRS's Use of Notices of Federal Tax Lien (NFTL)

FINDINGS

Sources of Payments on Tax Debts

We tracked the payments the 270,000 taxpayers made from 2002-2009, and discovered the IRS coded payments in a way that limited our ability to discern the source of slightly over half of all the payments made by these taxpayers. We limited our analysis to the payments we could track, and determined the sources for nearly \$905 million in payments. The sources of the \$905 million in payments are broken out in Figure 1.

FIGURE 1: Tax Payments by Source



The payments associated with NFTLs amount to less than one dollar out of every five dollars of payments of the traceable payment sources. Conversely, we found that payment sources not attributable to NFTLs were responsible for over four out of every five dollars the IRS collected. The largest source of payments came from the refund offsets (*i.e.*, the source of 42 percent of all payments), whereby the IRS collects tax debts by taking subsequent taxpayer refunds.

The second largest source of payments came from levies. The payments received from levies accounted for \$1 out of every \$3 in payments collected by the IRS. A levy is a legal tool the IRS uses to seize taxpayers' property to satisfy a tax debt, and is different from a lien. A lien is a claim used as security for the tax debt, while a levy actually takes the property to satisfy the debt. If taxpayers do not pay their taxes (or make arrangements to settle their debt), the IRS may acquire funds in the taxpayers' possession or monies due to the taxpayers, such as wages or Social Security payments. For instance, the IRS could levy property that belongs to taxpayers but is held by someone else (such as their wages, retirement accounts, or bank accounts).

The IRS's Use of Notices of Federal Tax Lien (NFTL)

The third largest source of payments came from NFTLs. A little less than one dollar out of every five dollars in payments was attributable to NFTLs. The IRS increased the number of liens filed by 475 percent between FY 1999 and FY 2009.³¹ Figure 2 below shows the number of liens issued by the IRS each year, and illustrates that the number of liens issued by the IRS rose almost every year over the past 11 years. During this same period, however, IRS total dollars collected actually declined by seven percent from \$29.4 billion to \$27.2 billion, when adjusted for inflation (in terms of real dollars valued as of 2009).

FIGURE 2: Inflation Adjusted Total Yield vs. Liens Issued



NFTLs Created Systemically

The IRS generates a majority of its liens through its Automated Collection System.³² Of the liens generated by ACS, we determined that just under two-thirds were created systemically.³³ The result is that nearly one-third of *all* NFTLs filed by the IRS are done so systemically and without significant employee involvement. The IRS generates these liens without reviewing the financial circumstances of these taxpayers and does not determine whether these taxpayers have any assets, or are likely to acquire assets to which the lien would attach.³⁴

³¹ IRS, *IRS Data Books, Table 16, Delinquent Collection Activities, 1999-2008*; IRS, *Collection Activity Report, NO-5000-C23, Collection Workload Indicators Reports* (Oct. 13, 2009). In FY 2009, the IRS filed 965,618 NFTLs.

³² IRS, *Collection Activity Report, NO-5000-C23, Collection Workload Indicators Reports* (Oct. 13, 2009). Of the 965,618 NFTLs filed in FY 2009, 491,822 (50.9 percent) were filed by ACS.

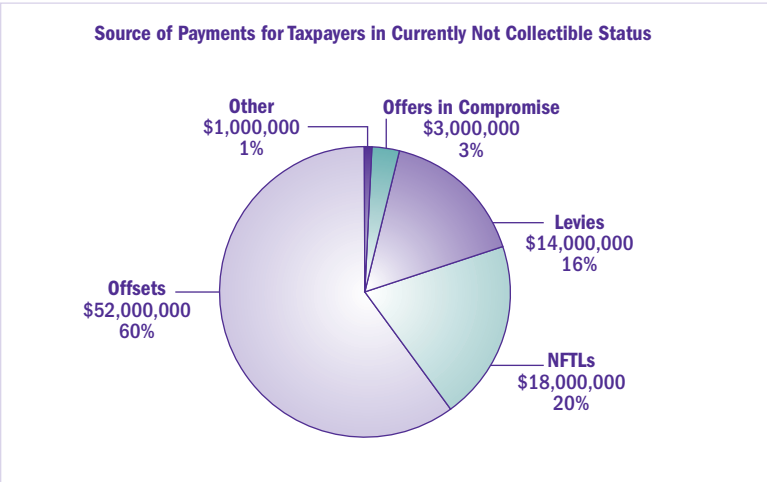
³³ ACS, *Customer Service Activity Reports (CSAR), FY 2009 BOD report*.

³⁴ ACS, *Customer Service Activity Reports (CSAR), FY 2009 BOD report*. See also IRS response to TAS Research & Analysis request (Oct. 30, 2009). ACS systemic programming retrieves cases with expired follow-ups in R7 status (accounts with a 25-day follow-up where the system generated an LT39, Reminder Notice), determines if the aggregate assessed balance is greater than \$5,000, and whether there are any modules without a lien. If all three criteria are met, the system requests the lien by inputting history code FM10 on the account. E-mail from IRS subject matter expert (Nov. 2, 2009). See also IRM 5.19.5.3.7, *Reminder Notices* (Dec. 1, 2007); IRM 5.19.5.5.7, *R7 – Lien Determinations (Follow-Up to LT39)* (May 29, 2008).

Sources of Payments for Taxpayers with Currently Not Collectible Accounts

We looked at the subset of the 270,000 taxpayers who were reported as CNC by the IRS.³⁵ For our analysis, we only included cases that the IRS placed in CNC status because the collection of the liability would create an economic hardship for the taxpayers and would leave them unable to meet necessary living expenses. Cases can also be reported CNC because the taxpayer could not be contacted or located; however, these cases were not included in our CNC analysis. The IRS reported about 13 percent of the taxpayers in our study as CNC due to economic hardship.³⁶ We examined the payment history for these taxpayers. The results are shown in Figure 3.

FIGURE 3: Payments from Taxpayers in CNC Status Due to Hardship



The largest source of payments for taxpayers whose accounts were designated as CNC was offsets. IRS refund offsets were responsible for nearly \$6 out of every \$10 in payments collected from taxpayers (see Figure 3). The significantly higher percentage of payments from refund offsets for hardship taxpayers when compared to all taxpayers suggests that these taxpayers have little ability to make voluntary subsequent payments. The next largest source of payments is liens, followed by levies. The use of liens by the IRS was responsible for \$2 out of every \$10 in payments collected from taxpayers.

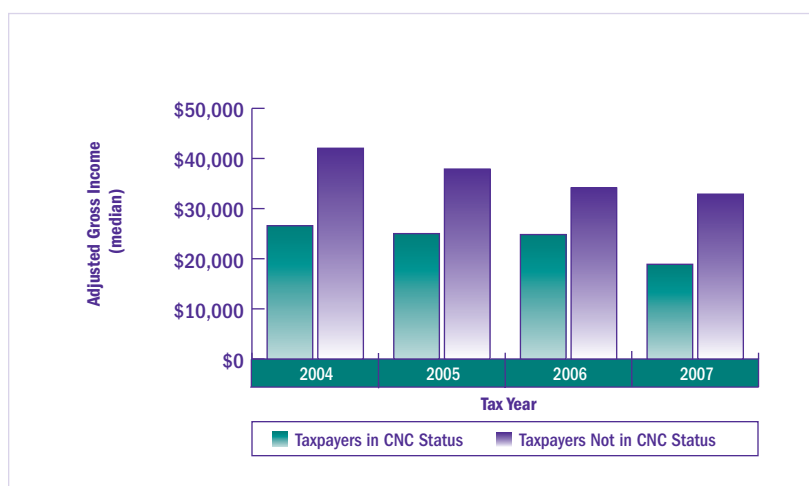
³⁵ CNC status means the IRS has determined it is currently unlikely to collect the tax liability from the taxpayer. TAS Research & Analysis pulled the subset of CNC Hardship taxpayers from the 270,399 individual taxpayers who first incurred new balance due delinquencies in TY 2002, had no previous unpaid tax liabilities at that time, and against whom NFTLs were filed in subsequent years. This analysis is based on the subset of payments that were refund offsets or had specific DPC coding. It does not include those payments that were coded as “Miscellaneous” or had no DPC coding. IRS, CDW, IMF Transaction File Cycle 200913.

³⁶ The IRS reported 35,919 of the taxpayers in this study as CNC due to economic hardship.

The IRS's Use of Notices of Federal Tax Lien (NFTL)

Taxpayers with CNC Accounts by Income Level

We looked at the income level of taxpayers who were in the CNC status when the lien was attached. We wanted to know if their income differed substantially from taxpayers not in CNC status. The results are shown in Figure 4.

FIGURE 4: Taxpayers with NFTLs and Income Level³⁷

The median adjusted gross income of taxpayers in the CNC status was roughly two thirds of the income of taxpayers not in the CNC status.

Dollars attributable to the filing of an NFTL are paid without regard to whether the taxpayer can afford to pay the monies extracted through the NFTL. For example, taxpayers whose liabilities the IRS reported CNC actually had a slightly higher percentage of their payments come from the filing of the NFTL. Given the CNC status of these taxpayers and their relatively low income levels, it is likely that the IRS is using its NFTL interest to secure payments that these taxpayers cannot afford to pay.

³⁷ Data is shown for TY 2004 –2007 due to incomplete income data for TYs 2003 & 2008. Income data was available for 21,500 of the 35,919 CNC taxpayers.

The IRS's Use of Notices of Federal Tax Lien (NFTL)

CONCLUSION

Overall, NFTLs can only be shown to generate a small portion of delinquent payments collected from taxpayers. Nevertheless, the IRS continues to increase the number of NFTLs filed on a yearly basis. The filing of a NFTL may have serious consequences for taxpayers, and this tool should only be used by the IRS when warranted by individual case circumstances.

Improved payment coding and additional research are needed to enable the IRS to better understand how effective the NFTL is as a collection tool, and to determine in what circumstances the filing of NFTLs is an effective collection action. Specific recommendations are contained hereafter.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that:

- The IRS should discontinue the policy of automatic NFTL filing on CNC hardship accounts with an unpaid balance of \$5,000 or more.
- The IRS should base lien filing determinations for all IRS contact employees on a thorough review of all the taxpayer's circumstances (including the existence and the value of assets, the taxpayer's financial information, the existence and amount of non-tax debt, and the ramifications of the lien on the taxpayer's credit rating).
- The IRS should institute a quality review of payment coding used to track taxpayers' payments for tax liabilities. An accurate method of tracking payments is an essential first step in determining the impact of various collection tools on taxpayers and the efficacy of their use.
- The IRS should study whether lien payments from CNC hardship taxpayers impose an economic hardship on these taxpayers.

The IRS's Use of Notices of Federal Tax Lien (NFTL)

Appendix 1

Transaction Code	Brief Description
640	Advanced payment of determined deficiency
641	Dishonored advanced payment
670	Subsequent payment
671	Dishonored subsequent payment
672	Correction of 670 processed in error
673	Input of a 672 changes existing 670 to 673
680	Designated payment of interest
681	Dishonored designated payment
682	Correction of 680 processed in error
690	Designated payment of penalty
691	Dishonored designated payment
692	Correction of 690 processed in error
694	Designated payment of fees and collection costs
695	Reverse designated payment of fees and collection costs
700	Credit applied
701	Reverse generated credit applied
702	Correction of erroneously applied credit
706	Generated overpayment applied from another tax module
710	Overpayment credit applied from a prior tax period
712	Correction of 710 or 716 processed in error
716	Generated overpayment credit applied from prior tax period
760	Substantiated credit payment allowance
762	Correction of 760 processed in error

The IRS's Use of Notices of Federal Tax Lien (NFTL)

Appendix 2

Designated Payment Code Description	Attributable to Lien or Not
00 - Designated payment indicator is not present on posting voucher	
01 - Non-trust fund (BMF MFT 01, 03, 09, 11 and 12)	Not NFTL
02 - Payment is applied first to the trust fund portion of the tax (BMF MFT 01, 03, 09, 11, and 12)	Not NFTL
03 - Bankruptcy, undesignated payment	NFTL
04 - Levied on state income tax refund (State Income Tax Levy Program (SITLP)) (prior to 07/22/1998)	Not NFTL
05 - Notice of levy (Other levy proceeds)	Not NFTL
06 - Seizure and sale	NFTL
07 - Federal tax lien	NFTL
08 - Suits (Non-Bankruptcy)	NFTL
09 - Offer in compromise	Not NFTL
10 - Installment agreement (Manually Monitored Installment Agreements)	Not NFTL
11 - Bankruptcy, designated to trust fund	NFTL
12 - Cash bond credit (allowed with TC 640 only)	Not NFTL
14 - Authorization given by taxpayer to apply payment to expired CSED account	Not NFTL
15 - Payments caused by Form 8519	Not NFTL
16 - Federal EFT levy payment	Not NFTL
17 - EFT payroll deduction installment agreement payment	Not NFTL
18 - FPLP payment for the Primary Taxpayer Identification Number (TIN). Payments are received electronically from Financial Management Service (FMS)	Not NFTL
19 - FPLP payment for the Secondary TIN. Payments are received electronically from FMS	Not NFTL
20 - State Income Tax Levy Program	Not NFTL
21 - Manual Posting of State Income Tax Levy Payments	Not NFTL
22 - Alaska Permanent Fund Dividend Levy Program	Not NFTL
23 - Alaska Permanent Fund Dividend Levy Program (AKPFD) receipt (used exclusively for manually applied payments)	Not NFTL
24 - Payment received with an amended return	Not NFTL
27 - Unknown	
28 - Unknown	
29 - Unknown	
31 - Exclude payment from systemic cross-reference processing to allow treatment of each spouse differently on a joint return	Not NFTL
33 - OIC \$150 application fee for offers submitted under TIPRA legislation	Not NFTL
34 - OIC 20 percent lump sum or initial periodic payment under TIPRA legislation	Not NFTL
35 - OIC subsequent payments made during the offer investigation under TIPRA legislation	Not NFTL
36 - Unknown	
38 - Unknown	
43 - Unknown	
47 - Installment Agreement User Fee, reduced initial fee, IMF only	Not NFTL
49 - Direct Debit Installment Agreement (DDIA) User Fee, initial fee	Not NFTL

The IRS's Use of Notices of Federal Tax Lien (NFTL)

Designated Payment Code Description	Attributable to Lien or Not
50 - Installment Agreement User Fee (IAUF). (Valid with MFT 13 (BMF) for tax period XXXX12 and with MFT 55 (IMF) for tax period XXXX01.)	Not NFTL
51 - Installment Agreement User Fee, Reinstatement fee	Not NFTL
53 - Discharges	NFTL
54 - Subordinations - Gov. agrees for NFTL to have lower priority in exchange for compensation from new superior lien holder	NFTL
55 - Subordinations	NFTL
56 - Withdrawals	NFTL
57 - Judicial and Non- Judicial Foreclosures	NFTL
58 - Redemptions; Release of Right of Redemptions	NFTL
59 - CID cases (182-Probation)	Not NFTL
80 - Unknown	
86 - Unknown	
89 - Unknown	
90 - Unknown	
99 - Miscellaneous payment other than above	

The IRS’s Use of Notices of Federal Tax Lien (NFTL)

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**SUBSEQUENT COMPLIANCE
BEHAVIOR OF DELINQUENT
TAXPAYERS: A COMPLIANCE
CHALLENGE FACING THE IRS**

Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge Facing the IRS

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Executive Summary

In this study, TAS Research examines the subsequent compliance behavior of individual taxpayers who incurred failure-to-pay delinquencies in 2002 following the last recession.¹ The study includes only taxpayers who had no prior unpaid tax liabilities at the time that they acquired their delinquencies. We chose this group because we believe its subsequent compliance behavior is indicative of the likely subsequent compliance behavior of the many taxpayers entering into delinquency during the current economic downturn.

The study tracks the compliance history of this cohort of taxpayers from the time their delinquencies began in 2002 through the first quarter of 2009. We explore the following questions:

- Was the IRS effective at keeping taxpayers compliant after the initial IRS disposition of their original liabilities?
- Does a financial analysis based solely on IRS allowable living expense (ALE) standards adequately capture the taxpayer's financial situation, or does it contribute to subsequent noncompliance?

The study then briefly reviews conditions in the current environment to assess the compliance challenges confronting taxpayers and the IRS.

FINDINGS

Taxpayers whose accounts were placed in the IRS Collection queue or in currently not collectible (CNC) status at first disposition had high levels of subsequent noncompliance. In addition, all taxpayers whose liabilities reached taxpayer delinquent account (TDA) status and were worked in the Automated Collection System (ACS) or by the Collection Field function (CFf) had especially high levels of subsequent noncompliance, regardless of their dispositions, as did taxpayers who had cancellation of debt income (CODI) or experienced bankruptcy at any time during the study period.

- **Taxpayers placed in queue:** About 54 percent of these taxpayers had subsequent payment delinquencies. About 76 percent had at least one subsequent payment delinquency or unfiled return.
- **Taxpayers placed in CNC status due to hardship:** About 45 percent of these taxpayers had subsequent payment delinquencies. About 59 percent had at least one subsequent payment delinquency or unfiled return.

¹ The recession preceding the current economic downturn ended in November 2001. National Bureau of Economic Research, *US Business Cycle Expansions and Contractions*, available at <http://www.nber.org/cycles/> (last visited Nov. 25, 2009).

Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge Facing the IRS

- **Taxpayers whose liability reached ACS or Cff:** Slightly over half of these taxpayers had subsequent payment delinquencies. About 74 percent had at least one subsequent payment delinquency or unfiled return.
- **Taxpayers who had CODI or experienced bankruptcy:** Over 61 percent of these taxpayers had subsequent payment delinquencies. About 68 percent had at least one subsequent payment delinquency or unfiled return.

A simulated financial analysis based on the ALE standards shows that taxpayers (particularly those whose accounts were placed in CNC status or who received CODI or experienced bankruptcy) have financial obligations that are not included in the standard ALE analysis. This finding suggests that many taxpayers may have liabilities that the IRS will not allow in its calculation of the taxpayers' ability to pay (*i.e.*, unsecured debt, or housing expenses that exceed the ALE allowance).

These liabilities could contribute to subsequent noncompliant behavior, since the amount the taxpayer is required to pay to the IRS may put some taxpayers in the position of deciding which creditor they will pay.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS study a representative sample of taxpayers with new payment delinquencies to determine the extent to which they have liabilities that are not allowed under current ALE standards. The study should also evaluate whether IRS installment agreement (IA) policies would cause these taxpayers to default on non-IRS liabilities.

If the study results confirm that current IRS IA policies are problematic, the National Taxpayer Advocate recommends that the IRS conduct a pilot study in which taxpayer payment agreements are based on a comprehensive review of the taxpayer's financial situation, with due consideration to all taxpayer liabilities.

The National Taxpayer Advocate also recommends that the IRS study the use of collection alternatives, such as the offer in compromise (OIC) program and partial payment installment agreements, in lieu of placing taxpayers in CNC status.² The agreements could be structured to have a finite duration and a flexible payment schedule contingent on the taxpayer's ability to pay throughout the duration of the agreement. The emphasis would be on ensuring that taxpayers remain current on future tax liabilities through the establishment of adequate withholding, or periodic direct debit estimated payments (*e.g.*, on a bi-weekly or monthly basis) for self-employed taxpayers.

² For a detailed discussion of the IRS OIC Program see Most Serious Problem: *The Steady Decline of the IRS Offer In Compromise Program is Leading to Lost Opportunities for Taxpayers and the IRS Alike*, Vol. I, *supra*.

Introduction

The current economic environment is placing severe financial stress on many taxpayers. This situation is reflected almost daily in media reports of prominent economic indicators, such as the unemployment rate, mortgage delinquencies and foreclosures, and depressed levels of private consumption. The National Taxpayer Advocate is concerned about the impact of these challenging conditions on taxpayers. She directed TAS Research to explore whether the downturn is significantly undermining taxpayers' ability to comply with their tax obligations.

This study examines the subsequent compliance behavior of individual taxpayers who incurred failure-to-pay delinquencies in 2002, following the last recession.³ The study includes only taxpayers who did not have prior unpaid tax liabilities at the time that they acquired their failure to pay delinquencies. A total of 6,200,289 taxpayers met these criteria and were included in the study. We chose this group because we believe their subsequent compliance behavior is indicative of the likely subsequent compliance behavior of the many taxpayers entering into delinquency during the current economic downturn.

The study tracks the subsequent compliance history of this cohort of taxpayers through the first quarter of 2009. We explore the following research questions:

- Was the IRS effective at keeping taxpayers compliant after the initial IRS disposition of their original liabilities?
- Does a financial analysis based solely on IRS allowable living expense standards adequately capture the taxpayer's financial situation, or contribute to subsequent noncompliance?

The study then briefly reviews conditions in the current environment to assess the compliance challenges confronting taxpayers and the IRS.

BACKGROUND

When individual taxpayers acquire a tax liability and do not pay it timely, they enter into notice status and receive a series of up to four IRS notices requesting payment over a period of about six months. Most taxpayers respond by paying their debts in full.⁴ Others contact the IRS to resolve their accounts, and as a result may enter into a payment agreement or be placed in currently not collectible status, if an IRS financial analysis determines

³ The recession preceding the current economic downturn ended in November 2001. National Bureau of Economic Research, *US Business Cycle Expansions and Contractions*, available at <http://www.nber.org/cycles/> (last visited Nov. 25, 2009).

⁴ Over 60 percent of the taxpayers included in this study full paid their initial tax liability during the IRS notice process.

Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge Facing the IRS

that they are unable to pay.⁵ The IRS conducts financial analyses using a set of standards for allowable living expenses, which are updated annually.⁶

Taxpayers that do not resolve their delinquencies during notice status enter into taxpayer delinquent account status at the conclusion of the notice stream. Their accounts are evaluated and prioritized automatically by the Inventory Delivery System and are then placed in one of several possible statuses based on their priority.⁷ The IRS shelves low priority cases and does not work them while they remain in that status, but may subsequently assign them another status to be worked when resources become available.⁸ The highest priority cases are assigned to the Collection Field function to be worked by revenue officers. Other high priority cases are either routed to the Automated Collection System, a telephone-based inventory management system, or placed in the queue. Cases placed in the queue remain inactive until CFF resources become available to work them, unless the liabilities are satisfied by the offset of a refund or a subsequent taxpayer payment.⁹

Accounts worked while in TDA status are resolved with the same dispositions as accounts resolved while still in notice status: taxpayers pay in full, enter into payment agreements, or are placed in CNC status.¹⁰

METHODOLOGY

TAS Research extracted individual taxpayer records with new liabilities becoming due during calendar year 2002 from the IRS Accounts Receivable Dollar Inventory (ARDI) module database, using the new record indicator on the database.¹¹ We compared these records to the ARDI entity database to remove taxpayers who had liabilities prior to 2002. We then added back taxpayer records if the prior liability was satisfied prior to 2002. The result was a cohort of taxpayers who became newly delinquent with balance due liabilities during 2002.¹²

We created a separate record for each distinct liability type and tax period. For example, a taxpayer with a new income tax liability and a new Trust Fund Recovery Penalty or with income tax liabilities from two different tax years would have two records.¹³ Nevertheless, for the final analysis, we only analyzed one record per taxpayer. In the event that the taxpayer

⁵ Internal Revenue Manual (IRM) 5.15.1 (Oct. 2, 2009).

⁶ IRS, Collection Financial Standards, available at <http://www.irs.gov/individuals/article/0,,id=96543,00.html> (last visited Dec. 14, 2009).

⁷ IRM 5.1.1.13 (Aug. 21, 2006).

⁸ Cases may be resolved while in shelved status by offsets of refunds or subsequent taxpayer payments.

⁹ Cases in the queue may be subject to systemic IRS levies such as the Federal Payment Levy Program (FPLP) or the State Income Tax Levy Program.

¹⁰ The IRS may take enforcement action, such as the issuance of a levy or the seizure of property, against taxpayers' whose accounts reach TDA status. As discussed above, taxpayers are placed in CNC status when the IRS determines that they are unable to pay their tax liabilities. The IRS also places taxpayer accounts in CNC status when it is unable to locate the taxpayer.

¹¹ This study does not include business liabilities, except for Trust Fund Recovery Penalties (TFRP) assessed against individual taxpayers in accordance with IRC § 6672.

¹² Taxpayers had no prior unsatisfied balance due liabilities at the time that their 2002 balance due liabilities arose; however, they may have had unfiled return delinquencies.

¹³ Some taxpayers had more than one new balance due liability occur during 2002.

had multiple new balances due during 2002, the oldest income tax liability was included in the analysis. Taxpayers with more than one liability in 2002 may have experienced different dispositions for their liabilities. For example, a taxpayer may have full paid one liability, while being placed in an IA to pay another. In these instances, we used the oldest income tax liability per taxpayer for the analysis of the liability dispositions. Taxpayers may also experience more than one disposition of the same liability; for example, the IRS may have placed a taxpayer into an installment agreement, which ultimately fully paid the liability. For purposes of this report, the initial disposition is the one considered in the analysis.

We classified cases into five possible disposition types:

- Shelved;
- Full pay;
- Queue;
- Currently Not Collectible; and
- Installment agreement.

We determined if cases were shelved or reported as CNC cases from the presence of transaction code 530 and the corresponding closing code from the IRS IMF Transaction Code History table. Full pay, queue, and installment agreement cases were determined from the Master File status code in the IMF Status History table. We used the cycle date of each of the aforementioned disposition types to determine the first disposition and the last disposition of the case.

We determined the presence of subsequent liabilities by using the IRS ARDI module file and Individual Master File (IMF) Status Code History file.¹⁴ A return was considered delinquent if unfiled by the due date (including extensions), since we could not reliably determine if a filing requirement existed.¹⁵ Because data at the beginning of this project was only available through the thirteenth week of 2009, no tax year (TY) 2008 return was considered to have a filing delinquency. Any balance due delinquency occurring for TY 2002 (due in calendar year 2003) or later was considered to be a subsequent balance due delinquency, even if the new liability was paid during notice status.

The IRS determines allowable living expenses by summing separate allowances for housing and utilities, transportation, health care, and an allowance from the IRS “National Standards” (which cover items such as food and clothing).¹⁶ We performed the analysis of IRS allowable living expenses by analyzing the taxpayer’s income and expenses in the year

¹⁴ The IMF Status Code History file had incomplete data for calendar years 2002 and 2003. TAS Research used the ARDI module file to identify calendar year 2002 and 2003 balance due liabilities.

¹⁵ TAS Research could attempt to reconstruct taxpayer incomes using data from information returns, such as Forms W-2 for wages, and Forms 1099 for interest and dividend income, but taxpayers may have had cash income that would not be reported on an information return.

¹⁶ IRM 5.15.1 (Oct. 2, 2009).

the case was first disposed, or in the year the taxpayer filed bankruptcy or received cancellation of debt income (Form 1099-C).¹⁷

To approximate the IRS allowable living expenses analysis, we used the taxpayer’s total positive income (TPI)¹⁸ and created a proxy for the IRS ALE amount by using the number of taxpayer exemptions to determine household size (the household size is needed to determine the National Standards allowance and the Housing and Utility allowance) and the taxpayer ZIP Code to determine his or her county of residence (the county of residence is also needed to determine the Housing and Utility allowance). We used a commercial ZIP Code product to map a taxpayer’s ZIP Code at time of the delinquency to the county of residence. The Housing and Utility allowable expense amount is the smaller of 30 percent of total positive income (from the return) or the IRS allowable expense amount.¹⁹ The 30 percent of total positive income is the highest Census American Community Survey (from the Census Bureau American Fact Finder) allowance for housing expenses. In some instances, either the taxpayer’s ZIP Code could not be matched to a county or the format of the county name differed from the format of the county name used by IRS. In these instances, the taxpayer’s housing allowance was set at 30 percent of the taxpayer’s total positive income. Transportation allowances were determined by using the average regional amount for ownership and operation of one or two cars. If the taxpayer had a spouse, two automobiles were allowed; otherwise only one was allowed. If applicable, health care expenses were based on the age of the taxpayer in accordance with IRM standards.²⁰

We determined a taxpayer’s ability to pay by subtracting the proxy for IRS allowable living expenses from the taxpayer’s total positive income. If the amount was positive and the residual amount of income after subtracting the allowable expense proxy would satisfy the liability within five years (the default timeframe for streamlined IAs), the taxpayer was considered a “can pay” taxpayer. Otherwise, we considered the taxpayer to be a “cannot pay” taxpayer.

FINDINGS

We present our findings in two sections. In the first section, we cover our findings on the subsequent compliance behavior of the taxpayers. We divide the study population into categories based on the initial IRS disposition of their liabilities, *e.g.*, some taxpayers full paid their initial liabilities during notice status, others entered into installment agreements with

¹⁷ Taxpayers with no return filed for the year of CODI, bankruptcy, or CNC were removed from the analysis.

¹⁸ TPI is calculated by summing the positive values from the following income fields from a taxpayer’s most recently filed individual tax return: wages; interest; dividends; distribution from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as zero.

¹⁹ The IRS requires taxpayers to provide documentation to substantiate their housing and utility expenses. IRS allows the lesser of the documented actual expenses or the ALE allowance. We therefore used the Census American Community Survey to estimate the actual amount of housing expenses and used the estimate rather than the ALE allowance if the estimate was lower.

²⁰ The IRS allows a higher allowance for taxpayers who are age 65 or over. We only had data for the age of the primary taxpayer, so other taxpayers are presumed to have the below age 65 health care allowance. The IRS began making an allowance for medical expenses in calendar year 2007.

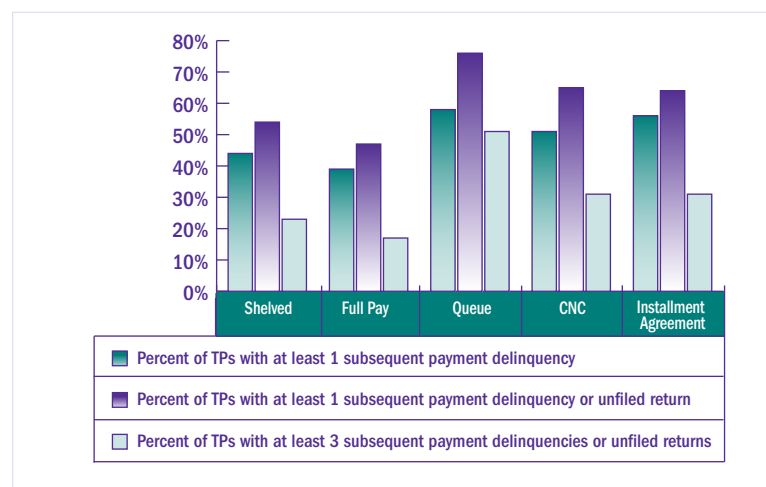
the IRS. In the second section, we present our findings on the adequacy of the IRS living expense guidelines in addressing the complete financial situation of taxpayers.

SUBSEQUENT COMPLIANCE BEHAVIOR OF DELINQUENT TAXPAYERS

TAS Research looked at whether taxpayers incurred additional delinquencies after the IRS determined a disposition for their original liabilities.²¹ We define delinquency as either non-payment of an assessed balance due on a timely basis or failure to file a return on a timely basis. It is important to note that we could not determine whether taxpayers had a filing requirement for unfiled returns, since we cannot reliably determine their incomes in the years they did not file.²²

Subsequent Noncompliance by Type of First Disposition of the Original Liability

FIGURE 1: Taxpayers with Delinquencies



Shelved taxpayers – There were 441,740 taxpayers who had their original tax liabilities shelved at first disposition. About 53 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 21 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 42 percent of these taxpayers accrued subsequent tax liabilities.

Full pay taxpayers – There were 4,026,083 taxpayers who full paid their original tax liabilities. About 46 percent of these taxpayers had at least one subsequent payment delin-

²¹ In many cases, the initial disposition of a case may change later on. For example, a case that was originally shelved might later be worked and enter into installment agreement or full pay status.

²² TAS Research could attempt to reconstruct taxpayer incomes using data from information returns, such as Forms W-2 for wages, and Forms 1099 for interest and dividend income, but taxpayers may have had cash income that would not be reported on an information return.

Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge Facing the IRS

quency or unfiled return. About 17 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 39 percent of these taxpayers accrued subsequent tax liabilities.

Taxpayers placed in queue – There were 62,496 taxpayers who were placed in the queue at the time of first disposition. About 76 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 46 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, about 54 percent of these taxpayers accrued subsequent tax liabilities.

Taxpayers placed in CNC status due to hardship – There were 25,450 taxpayers who were placed in CNC status due to hardship at first disposition.²³ About 59 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 26 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 45 percent of these taxpayers accrued subsequent tax liabilities.

We also examined the liability amount of taxpayers whose 2002 liabilities were reported as CNC due to hardship. Of these, 61 percent still had at least one payment delinquency as of the 44th week of 2009. At the time the original liability arose for these taxpayers in 2002, the median balance due amount was just under \$3,500, while the median balance due in the last quarter of 2009 was nearly \$8,600.²⁴

Taxpayers placed in an installment agreement – There were 1,437,595 taxpayers who were placed in IAs at the time of first disposition. About 64 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 31 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 56 percent of these taxpayers accrued subsequent tax liabilities.

Taxpayer Groups with Especially High Subsequent Noncompliance

As noted above, taxpayers whose accounts were placed in the queue or in CNC status at first disposition had high levels of subsequent noncompliance. In addition, all taxpayers whose liabilities reached TDA status and were worked in ACS or by the CFf had especially high levels of subsequent noncompliance, regardless of their disposition.²⁵ Taxpayers who had CODI or experienced bankruptcy at any time during the study period also had very high levels of subsequent noncompliance.

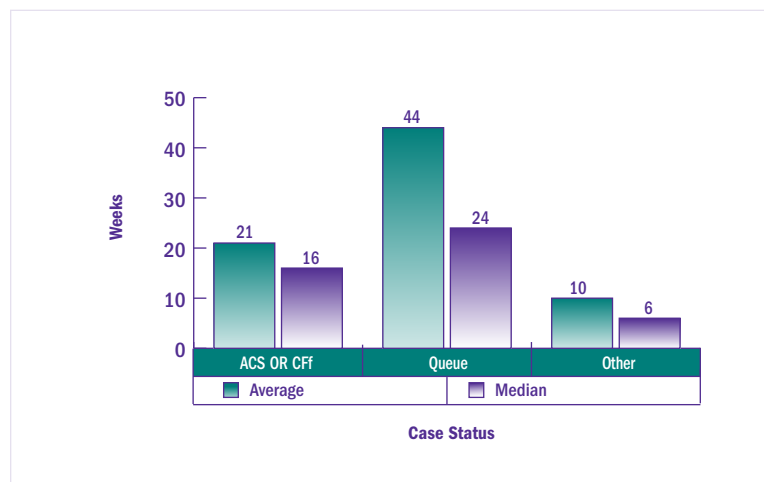
²³ Another 197,136 taxpayers had liabilities that were reported CNC for reasons other than hardship.

²⁴ While the 2009 liabilities may include new liabilities subsequent to those arising in 2002, this data shows that CNC dispositions often fail to bring taxpayers into compliance and can result in substantial additional revenue loss. This problem could be ameliorated if the original liability were satisfied through a collection alternative, such as an OIC, that required subsequent filing and payment compliance.

²⁵ Taxpayers can enter into a disposition, such as full pay or CNC status, from either notice status or TDA status. Taxpayers whose accounts reached TDA status before initial disposition had much higher levels of subsequent noncompliance, regardless of the disposition of their liabilities.

When considering liabilities that were ultimately paid in full by the taxpayer, we also found that once balance due delinquencies reach ACS or the field, the time to dispose of these cases is much longer. On average, ACS or CFf took twice as many weeks to initially dispose of a new balance due case in 2002 as were required to dispose of cases that did not reach TDA status. The average time for ACS or CFf to initially dispose of a case where the taxpayer ultimately full paid the liability was 21 weeks and the median was 16 weeks. In contrast, the average time to initially dispose of other balance due delinquencies never in ACS, CFf, or the queue was only ten weeks and the median number was six weeks. For cases reaching TDA status but also spending time in the Collection queue, the average time to initially dispose of these cases was 44 weeks and the median time was 24 weeks.²⁶

FIGURE 2: Amount of Time to Initial Disposition of Delinquency Cases When Taxpayer Ultimately Full Pays Liability



Taxpayers whose liability reached TDA status – There were 553,799 taxpayers whose initial liability reached TDA status. About 74 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 41 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 61 percent of these taxpayers accrued subsequent tax liabilities.

Taxpayers who had CODI or experienced bankruptcy – There were 538,744 taxpayers who had CODI or who experienced bankruptcy at some time during the study period. About 71 percent of these taxpayers had at least one subsequent payment delinquency or unfiled return. About 36 percent had at least three such delinquencies. When considering only subsequent payment delinquencies, 62 percent of these taxpayers accrued subsequent tax liabilities.

²⁶ Includes only cases where the liability was ultimately full paid.

IRS ALLOWABLE EXPENSES DO NOT FULLY REFLECT TAXPAYERS' FINANCIAL CONDITION

TAS Research conducted a simulated financial analysis to determine a taxpayer's ability to pay using IRS ALE standards. We determined the taxpayer's income using the taxpayer's total positive income as reported on his or her tax return.²⁷ We then developed an estimate of allowable expenses based on the ALE standards, and determined how much income the taxpayer had left over after allowable expenses. If the taxpayer had sufficient income left over to pay off his or her liability over five years, the default timeframe for streamlined installment agreements, we classified the taxpayer as a "can pay" taxpayer.²⁸

We conducted this analysis on three different groups of financially stressed taxpayers: taxpayers who were placed in CNC status due to financial hardship, taxpayers who had CODI, and taxpayers who declared bankruptcy. We conducted the analyses during the year in which they experienced the financial stress (*e.g.*, if a taxpayer declared bankruptcy in 2003, we used the TY 2003 return and ALE standards to determine ability to pay).

Taxpayers who were classified as CNC due to hardship – About a quarter of CNC taxpayers show as "can pay" taxpayers in the year their modules were disposed of as CNC.²⁹ This result demonstrates that these taxpayers had additional expenses beyond those reflected in the ALE standards. While the IRS did allow these expenses, it would not have allowed any unsecured debt, which is included in the two groups below.

Taxpayers with Unsecured Liabilities – Because the IRS does not include unsecured debt and limits allowable housing expenses in the financial analyses that determine a taxpayer's ability to pay, it may in effect force some taxpayers to have to choose which creditors they will pay. This may result in taxpayer defaults on payment agreements and new tax delinquencies.

Taxpayers with cancellation of debt income – In all years during which taxpayers received CODI, at least 50 percent were identified as "can pay" taxpayers. In many cases, these taxpayers probably had liabilities they could not pay (*i.e.*, the debt underlying the CODI) that the IRS does not recognize, since only secured liabilities (*e.g.*, real estate and automobile loans) are included in ALE calculations.³⁰

Taxpayers who experienced bankruptcy – In all years during which taxpayers declared bankruptcy, over 50 percent were identified as "can pay" taxpayers. In many cases, these

²⁷ TPI is calculated by summing the positive values from the following income fields from a taxpayer's most recently filed individual tax return: wages; interest; dividends; distribution from partnerships, small business corporations, estates, or trusts; Schedule C net profits; Schedule F net profits; and other income such as Schedule D profits and capital gains distributions. Losses reported for any of these values are treated as zero.

²⁸ IRM 5.14.5.2 1(c).

²⁹ 24.2 percent of CNC taxpayers showed as "can pay" in the year their modules were disposed of.

³⁰ IRS allowable expense standards allow taxpayers set amounts for ownership and operation of up to two automobiles.

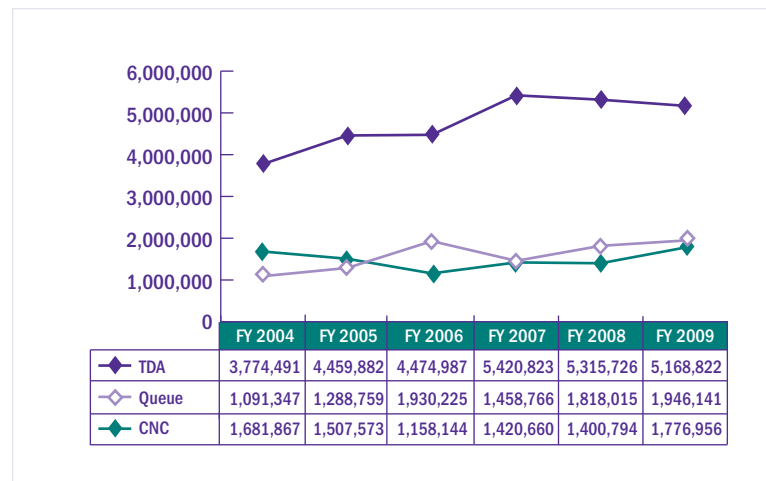
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taxpayers probably had liabilities they could not pay that IRS does not recognize, since only secured liabilities (*e.g.*, real estate and automobile loans) are included in ALE calculations.

COMPLIANCE CHALLENGES CURRENTLY FACING THE IRS

The IRS is experiencing high levels of new individual taxpayer payment delinquencies in categories that could produce high levels of subsequent noncompliance. Figure 3 below shows receipts by fiscal year (FY) of three categories of taxpayer delinquency cases that our research showed to have problematic subsequent noncompliance.

FIGURE 3: Delinquencies with High Levels of Subsequent Noncompliance³¹



The number of taxpayers receiving CODI also is continuing to grow. Figure 4 shows the number of taxpayers who received COD income by tax year.

FIGURE 4: Number of Taxpayers Receiving CODI (Form 1099-C) by Tax Year³²

2002	2003	2004	2005	2006	2007	2008
978,173	1,049,460	1,116,432	1,635,820	1,452,293	1,644,934	1,939,559

Recent data reported by the Federal Reserve Board show that many taxpayers are having difficulty meeting their financial obligations. Charge-off rates for both real estate and consumer loans are continuing to rise, as shown in Figure 5 below, suggesting that the number of taxpayers experiencing financial distress is still growing.

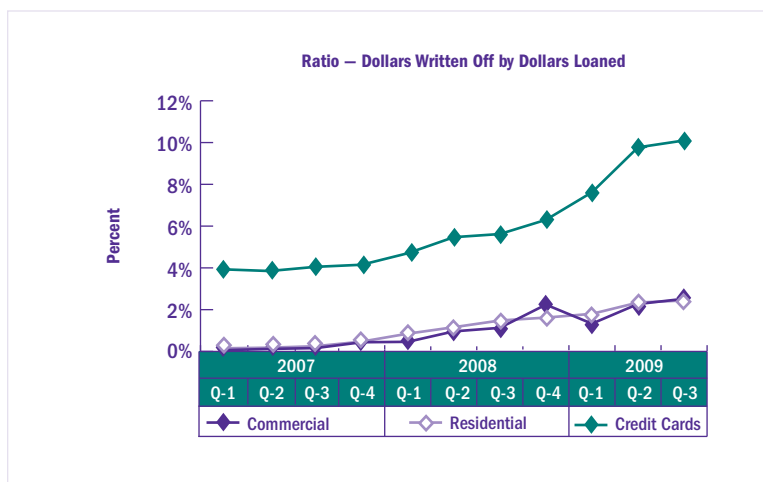
³¹ IRS, Small Business/Self-Employed (SB/SE) Division, *Collection Activity Report NO-5000-2/242, Taxpayer Delinquent Account Cumulative Report* (Sept. 28, 2008); SB/SE, *Collection Activity Report NO-5000-149, Recap of Accounts Currently Not Collectible Report* (Oct. 5, 2009). The counts for TDA, queue and CNC receipts overlap because some TDA receipts had queue or CNC dispositions during the year in which they were received.

³² TAS Research analyzed Information Returns Master File data available on the Compliance Data Warehouse to obtain the results presented in this table.

Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge Facing the IRS

Credit card debt is particularly problematic for taxpayers, since the IRS does not include unsecured debt in its calculation of a taxpayer's ability to pay. Residential real estate debt may be problematic as well, since the IRS limits allowable housing expenses in the calculation.

FIGURE 5: Real Estate and Consumer Loan Charge-Offs³³



Mortgage delinquencies and foreclosures also reflect that taxpayers are experiencing a high level of financial distress. The Mortgage Bankers Association (MBA) reported that 2009 third quarter delinquencies and foreclosures reached record highs (MBA data dates back to 1972):

The percentages of loans 90 days or more past due, loans in foreclosure, and foreclosures started all set new record highs.

The percentage of loans in the foreclosure process at the end of the third quarter was 4.47 percent, an increase of 17 basis points from the second quarter of 2009 and 150 basis points from one year ago. The combined percentage of loans in foreclosure or at least one payment past due was 14.41 percent on a non-seasonally adjusted basis, the highest ever recorded in the MBA delinquency survey.³⁴

This challenging economic environment likely impedes taxpayers' ability to comply with their tax obligations, and suggests that new taxpayer payment delinquencies will remain high in the current fiscal year.

³³ Federal Reserve Statistical Release, *Charge-off Rates on Loans and Leases at Commercial Banks* (Not Seasonally Adjusted), available at <http://www.federalreserve.gov/releases/chargeoff/chgallnsa.htm> (last visited Nov. 25, 2009). Residential and commercial loans are real estate loans; credit cards are consumer loans.

³⁴ Mortgage Bankers Association, Press Release: *Delinquencies Continue to Climb in Latest MBA National Delinquency Survey* (Nov. 19, 2009) available at <http://www.mbaa.org/NewsandMedia/PressCenter/71112.htm> (last visited Nov. 25, 2009).

CONCLUSION

The TAS Research analysis tracked the subsequent compliance behavior of taxpayers who acquired an unpaid tax liability in 2002, and who did not have an outstanding prior liability at that time. Certain groups of taxpayers had high levels of subsequent noncompliance: taxpayers reaching TDA status; taxpayers who received COD income at any time during the study period; taxpayers placed in the queue, and taxpayers placed in CNC status.

A simulated financial analysis based on the ALE standards shows that many of these taxpayers have financial obligations that are not included in the standard ALE analysis, and suggests that many taxpayers may have liabilities that the IRS will not allow in its calculation of their ability to pay. The existence of these liabilities may contribute to subsequent noncompliant behavior, since the amount the taxpayer is required to pay to the IRS may put some taxpayers in the position of deciding which creditor they will pay.

Current elevated levels of payment noncompliance and taxpayer delinquencies on consumer and residential loans demonstrate that taxpayers are experiencing severe financial distress. The challenging economic environment and high levels of consumer and residential loan delinquencies suggest the IRS may need to offer more flexible payment arrangements to enable delinquent taxpayers to become and remain compliant with their tax obligations.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that the IRS study of a representative sample of taxpayers with new payment delinquencies to determine the extent to which they have liabilities that are not allowed under current ALE standards. The study should also evaluate whether current IRS installment agreement policies would cause these taxpayers to default on non-IRS liabilities.

If the study results confirm that current IRS installment agreement policies are problematic, the National Taxpayer Advocate recommends that the IRS conduct a pilot study in which taxpayer payment agreements are based on a comprehensive review of the taxpayer's financial situation, with due consideration to all taxpayer liabilities.

The National Taxpayer Advocate also recommends that the IRS study the use of collection alternatives, such as the offer in compromise program and partial payment installment agreements, in lieu of placing taxpayers in CNC status. The agreements could be structured to have a finite duration and a flexible payment schedule contingent on the taxpayer's ability to pay throughout the duration of the agreement. The emphasis would be on ensuring that taxpayers remain current on future tax liabilities through the establishment of adequate withholding, or periodic direct debit estimated payments (*e.g.*, on a bi-weekly or monthly basis) for self-employed taxpayers.

Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge Facing the IRS

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**AN ANALYSIS OF TAX
ADMINISTRATION ISSUES RAISED
BY A CONSUMPTION TAX, SUCH
AS A NATIONAL SALES TAX OR
VALUE ADDED TAX**

An Analysis of Tax Administration Issues Raised by a Consumption Tax,
Such as a National Sales Tax or Value Added Tax

An Analysis of Tax Administration Issues Raised by a Consumption Tax, Such as a National Sales Tax or Value Added Tax ¹

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¹ The principal author of this study is Eric LoPresti, Senior Attorney Advisor to the National Taxpayer Advocate. The National Taxpayer Advocate would like to thank Eric Toder and Michael Keen for offering helpful comments on short notice.

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INTRODUCTION

Why is the National Taxpayer Advocate discussing consumption taxes?

The National Taxpayer Advocate is required to include legislative recommendations in her Annual Report to Congress to resolve problems encountered by taxpayers.² Consumption taxes are being discussed by policy experts and legislators as a means to raise revenue that could be used to reform other taxes, reduce the deficit, or for other purposes, as described below. Any consumption tax proposal should be analyzed to ensure it is administrable and minimizes opportunities for noncompliance and conflict. In connection with her testimony before the President's 2005 Tax Reform Panel, the National Taxpayer Advocate developed a number of tax reform principles with these goals in mind, as follows:³

- The tax system should not “entrap” taxpayers;
- The Internal Revenue Code should be simple enough that taxpayers can prepare their own returns without professional help;
- The tax system should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance;
- The tax law should provide some choices, but not too many choices;
- Refundable credits are not inherently problematic – it's all in the design; and
- The tax system should incorporate a periodic review of the tax code – in short, a sanity check.

The sole purpose of this report is to highlight tax administration issues that policymakers should consider as they evaluate consumption tax proposals. The National Taxpayer Advocate is not taking a position with respect to the imposition of any new tax.

Why is a value added tax (VAT) or retail sales tax (RST) being considered?

A value added tax (VAT) is similar to a retail sales tax (RST). Instead of being collected all at once on retail sales, however, it is collected at each stage of production. Assuming, for example, that gasoline sells for the total of the value added by an oil producer, refiner, distributor, and gas station, a small tax would be due from each. By contrast, under an RST the government collects the entire tax from the retailer – the gas station in this example.⁴

² See IRC § 7803(c)(2)(B)(ii)(VIII)-(XI) (requiring this report to include “recommendations for such administrative and legislative action as may be appropriate to resolve problems ... [recommendations for remedying] compliance burdens ... [and] such other information as the National Taxpayer Advocate may deem advisable”).

³ See National Taxpayer Advocate, *Testimony before the President's Advisory Panel on Federal Tax Reform* (Mar. 2005), <http://www.irs.gov/pub/irs-utl/ntacomplexity030105final3.ppt>. For further discussion of these principles, see National Taxpayer Advocate 2005 Annual Report to Congress 375 (Key Legislative Recommendation: *A Taxpayer-Centric Approach to Tax Reform*).

⁴ Sellers are sometimes required to reflect RST or VAT on receipts and this may create the expectation that they have passed the tax along to customers. While some may in fact pass the entire tax cost on to customers, others might reduce prices to retain the same after-tax price.

An Analysis of Tax Administration Issues Raised by a Consumption Tax, Such as a National Sales Tax or Value Added Tax

Since a VAT was first used as a national tax about 60 years ago, more than 140 countries have adopted it, including China, Russia, India, and every member of the Organization for Economic Cooperation and Development (OECD) except the United States.⁵ Every OECD country that has a VAT also has an income tax.⁶

Experts have suggested that the revenue generated by a U.S. VAT could be used to finance deficit reduction, entitlement reform (including health care), or to eliminate the income tax applicable to corporations or low and middle income individuals.⁷ Revenue needs and renewed interest in pay-as-you-go deficit control legislation may accelerate this debate.⁸ The Congressional Budget Office (CBO) projects that the public will hold \$7.6 trillion in U.S. debt by the end of 2009, and this figure will nearly double to \$14 trillion as we add another \$7 trillion in cumulative deficits over the 2010 to 2019 period.⁹

According to one estimate, each percentage point of a VAT could generate revenue in the range of 0.4 to 0.6 percent of GDP, depending on the number of exemptions and preferences.¹⁰ Based on the 2008 GDP of \$14.44 trillion, this estimate suggests each VAT percentage point could raise revenue in the range of \$58 billion to \$87 billion per year.¹¹ By comparison, the corporate income tax, which taxes most corporate income at the top

⁵ See Leah Durner et al., *Why Vat Around the Globe?*, 2009 TNT 223-7 (Nov. 23, 2009) (citing 1948 as the first VAT adoption date and listing 145 countries); OECD, *Consumption Tax Trends*, Annex 2 (2008) (listing 143 countries); Government Accountability Office (GAO), GAO-08-566, *Value-Added Taxes: Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition* 9 (Apr. 2008) (hereinafter GAO Report) (citing 1954 as the first VAT adoption date).

⁶ GAO Report at 9. A VAT is a requirement for membership in the European Union (EU). Sixth Council Directive, *On the Harmonization of the Laws of the Member States Relating to Turnover Taxes – Common System of Value Added Tax: Uniform Basis of Assessment*, Official J. No. L145 (May 17, 1977), recast by Council Directive, *On the Common System of Value Added Tax*, Official J. No. L347 (Nov. 28, 2006) (hereinafter Recast Sixth Directive).

⁷ See, e.g., *Financing Healthcare Reform, Testimony Before the Senate Committee on Finance* (May 12, 2009) (statement of Leonard E. Burman); Kenneth J. Kies, *The Obama Budget, 2010, and the Impending Fiscal Nuclear Winter*, 123 Tax Notes 601 (May 4, 2009); Alan Auerbach and William Gale, *The Economic Crisis and the Fiscal Crisis: 2009 and Beyond*, Tax Policy Center (June 23, 2009); Rudolph Penner, *Do We Need a Value-Added Tax to Solve Our Long-Run Budget Problems?*, Urban Institute (June 22, 2009); Reuven S. Avi-Yonah, *An Add-on VAT for the United States: Summary and Recommendations*, ABA Section of Taxation May 2009 Meeting (Feb. 9, 2009) (conference draft); Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 Yale L. J. 261 (Oct. 16, 2002). Fiscal pressures recently prompted California to consider a VAT. See California's Commission on the 21st Century Economy, Final Report (Sept. 2009), <http://www.cotce.ca.gov/documents/reports/> (recommending lowering personal income tax rates, and eliminating sales, use, and corporate income taxes with revenue from a subtraction method VAT, called a "Business Net Receipts Tax"). The policy benefits of a VAT are the subject of debate. See, e.g., Curtis S. Dubay, WebMemo #2532, *Value-Added Tax: No Solution for Health Care or Fiscal Woes*, Heritage Foundation (July 9, 2009) (arguing a VAT would lead to more government spending).

⁸ See, e.g., Congressional Budget Office (CBO), *An Analysis of H.R. 2920, the Statutory Pay-As-You-Go Act of 2009* (July 14, 2009) (letter to Paul Ryan). Based on the conclusion that revenue needs will spark this debate, KPMG's Washington National Tax Office is conducting an initiative to inform the debate over the VAT as a tax reform option in the United States. See Leah Durner et al., *Why All the Buzz About VAT?*, 2009 TNT 199-7 (Oct. 19, 2009).

⁹ CBO, *The Budget and Economic Outlook: An Update ix*, 2 (Aug. 2009), <http://www.cbo.gov/ftpdocs/105xx/doc10521/08-25-BudgetUpdate.pdf>. Other estimates suggest we may add more than \$12 trillion to the deficit over this period. *Ten-Year Deficit Could Top \$12 Trillion, Says Budget Watchdog Group*, 2009 TNT 170-3 (Sept. 4, 2009).

¹⁰ William G. Gale and C. Eugene Steuerle, *Tax Policy Solution*, in *RESTORING FISCAL SANITY* 113 (Alice M. Rivlin and Isabel Sawhill, eds., Brookings Institution Press 2005). This is consistent with a more recent estimate, which suggests a 5 percent VAT could raise \$3.3 trillion over 10 years. *Tax Policy Center Estimates Impact of 5 Percent VAT*, 2009 TNT 224-41 (Nov. 24, 2009), <http://www.taxpolicycenter.org/numbers/Content/pdf/T09-0442.pdf>.

¹¹ Bureau of Economic Analysis, *National Income and Product Accounts Table 1.1.5, Gross Domestic Product* (Sept. 30, 2009).

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statutory rate of 35 percent, generated about \$354 billion in fiscal year (FY) 2008 – only about \$10 billion per point.¹²

Most major analyses of U.S. tax reform options include VAT-like taxes, but they are rarely called VATs. For example, some VATs and VAT-like taxes are called Goods and Services Taxes (GST), Business Transfer Taxes (BTT), Business Activity Taxes (BAT), Flat Taxes, X-Taxes, or Growth and Investment Taxes (GIT).¹³ Some would be computed using the standard “credit invoice” method, and others, such as a flat tax, would be computed using a “subtraction method,” as described below.¹⁴

Some surveys suggest that U.S. taxpayers would prefer a national RST to a federal income tax increase.¹⁵ Politicians and experts, including two former Federal Reserve chairmen, Alan Greenspan and Paul Volcker, the Speaker of the House of Representatives, Nancy Pelosi, and the Senate Budget Committee Chair, Kent Conrad, have recently joined those suggesting the U.S. may need to consider a VAT or VAT-like tax.¹⁶

What types of VATs have been proposed?

A diverse group of U.S. policymakers and tax experts have been considering VATs and VAT-like taxes for decades, either as supplements or replacements for the income tax. To highlight just a few:

- The Nixon Administration considered a VAT in the early 1970s to fund grants to state and local governments to finance education;¹⁷
- Former Ways and Means Committee Chairman Ullman proposed a credit invoice method VAT in 1980 to fund cuts in income and payroll taxes;¹⁸

¹² See IRS Pub. 55B, Data Book, *Table 1 – Collections and Refunds, by Type of Tax* (2008) (corporate tax receipts); IRC § 11 (corporate tax rate). These figures are computed as follows: \$354 billion in corporate tax receipts / 35 percent = \$10 billion per point. According to preliminary figures, however, corporate income tax receipts fell by more than 55 percent in FY 2009. Joint Statement of Tim Geithner, Secretary of the Treasury and Peter Orszag, Director of the Office of Management and Budget, on *Budget Results for Fiscal Year 2009*, TG-322 (Oct. 16, 2009). VAT revenues are generally less volatile than income tax revenues.

¹³ See, e.g., Alvin Warren, *The Business Enterprise Income Tax: A First Appraisal*, 118 Tax Notes 921 (Feb. 25, 2008).

¹⁴ The method we refer to as “credit invoice” is sometimes called “credit-subtraction” and the method we refer to as “subtraction” is sometimes called “sales-subtraction.”

¹⁵ According to a national survey, “[F]orty-eight percent (48%) say a national sales tax is fairer than an income tax while 26% hold the opposite view.” Rasmussen Reports, *18% Favor National Sales Tax, 68% Oppose* (May 29, 2009), http://www.rasmussenreports.com/public_content/business/taxes/may_2009/18_favor_national_sales_tax_68_oppose. These views are consistent with survey results from the 1980s, which found that taxpayers would prefer a national sales tax to an income tax increase. See Congressional Research Service (CRS), *The Value-Added Tax: Concepts, Issues, and Experience*, reprinted in 47 Tax Notes 447 (Apr. 23, 1990) (citing a 1983 Gallup survey, a 1988 Harris poll, and a 1988 Media General Research poll). One study suggested a significant number of U.S. taxpayers favor replacing the income tax with a flat tax or RST, in part, because of the misconception that the income tax is regressive. Joel Slemrod, *The Role of Misconceptions in Support for Regressive Tax Reform*, 59 Nat'l Tax J. 57-75 (Mar. 2006).

¹⁶ See, e.g., Sam Goldfarb, *Policy Experts Revisit VAT as Debt Crisis Looms*, 2009 TNT 152-1 (Aug. 11, 2009); Lori Montgomery, *Once Considered Unthinkable, U.S. Sales Tax Gets Fresh Look*, Washington Post, May 27, 2009; Robert Altman, *We'll Need to Raise Taxes Soon, Expect Congress to Seriously Consider a Value-Added Tax*, The Wall Street Journal, A15, June 30, 2009; The Charlie Rose Show, with Nancy Pelosi, Current Affairs (Oct. 5, 2009); Jeanne Sahadi, *We're Broke ... Time for a New Tax*, CNNMoney.com (Oct. 12, 2009).

¹⁷ The Report of the President's Task Force on Business Taxation 61 (1970).

¹⁸ Tax Restructuring Act of 1980, H.R. 7015, 96th Cong. § 301 (1980).

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- Treasury Department officials discussed a VAT as an option for reforming business taxes in 1984, 2002, and 2007;¹⁹
- Senator Roth proposed a subtraction method VAT (called a Business Transfer Tax) in 1985 and suggested that 85 percent of the burden would be borne by importers;²⁰
- The American Bar Association (ABA) Tax Section developed a model credit invoice method VAT in 1989;²¹
- Senator Hollings proposed credit invoice method VATs in 1989 and 1991 to fund deficit reduction and national health care;²²
- In 1994 Congressman Armey and Senator Shelby proposed to replace the corporate and individual income taxes with a subtraction method VAT and a wage tax at the same flat rate (called a flat tax) and this concept was later endorsed by Steve Forbes in connection with his 1996 run for the presidency;²³
- Senators Nunn, Domenici, and Kerrey proposed a modified subtraction method VAT (called a Unlimited Savings Allowance or USA Tax) in 1995, which was also proposed by Congressman English in 2003 as a replacement for the corporate income tax along with modifications to the individual income tax;²⁴
- President Bush’s bipartisan Advisory Panel on Federal Tax Reform considered a VAT and a flat tax in 2005;²⁵
- Governor Huckabee proposed a national RST in connection with his 2008 run for the presidency;²⁶ and

¹⁹ See Treasury Department, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (Dec. 20, 2007), http://www.ustreas.gov/press/releases/reports/hp749_approachesstudy.pdf; Tax Reform Materials Memorandum for Secretary O’Neil from Pamela F. Olson (Nov. 7, 2002), <http://thepriceofloyalty.ronsuskind.com/thebushfiles/archives/000093.html>; Treasury Department Report to the President, *Tax Reform, Fairness, Simplicity, and Economic Growth*, vol. 1, ch. 10 and vol. 3 (Nov. 1984), <http://www.treas.gov/offices/tax-policy/library/tax-reform/>.

²⁰ See, e.g., Tax Foundation, Working Paper, *Uses of a Business Transfer Tax 2* (Dec. 20, 1985), <http://www.taxfoundation.org/files/wp5-19851220.pdf>. See also Alan Schenk, *The Business Transfer Tax: The Value Added by Subtraction*, 30 Tax Notes 351 (1986).

²¹ Alan Schenk, ABA, *Value Added Tax: A Model Statute and Commentary* vii (1989) (hereinafter ABA Model VAT). The staff of the International Monetary Fund has also drafted a number of model VAT statutes. See *Tax Law Design and Drafting*, vol. 1, ch. 6 (Victor Thuronyi, ed. International Monetary Fund 1996); *Tax Law Drafting Samples: VAT Including Hypothetical Tax Laws* (Jan. 24, 2006), <http://www.imf.org/external/np/leg/tlaw/2003/eng/tlvat.htm>.

²² Deficit and Debt Reduction and Health Care Financing Act of 1995, S. 237, 104th Cong. (1995).

²³ Freedom and Fairness Restoration Act, H.R. 2060, 104th Cong. (1995); Freedom and Fairness Restoration Act of 1995, S. 1050, 104th Cong. (1995). See also, CRS, RL98529, *Flat Tax: An Overview of the Hall-Rabushka Proposal 1* (Feb. 1, 2008). In 1997, then-Texas Governor George W. Bush proposed replacing the Texas franchise tax with a modified value added tax. Martin Sullivan, *Business Tax Reform: Lessons from Texas*, 48 State Tax Notes 347 (May 5, 2008).

²⁴ USA Tax Act, S. 722, 104th Cong. (1995); Simplified USA Tax Act of 2003, H.R. 269, 108th Cong. (2003). Like the flat tax, this bill also included modifications to the income tax.

²⁵ Report of the President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System* (Nov. 2005), <http://govinfo.library.unt.edu/taxreformpanel/final-report/index.html>.

²⁶ See, e.g., Bruce Bartlett, *Why the FairTax Won’t Work*, 117 Tax Notes 1241 (Dec. 24, 2007).

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- At least six bills proposed a VAT or modified VAT in just the first half of 2009.²⁷

Most OECD countries have shifted from RSTs and gross receipts taxes to credit invoice method VATs, and the only OECD country with a subtraction method VAT is Japan.²⁸ Nonetheless, many of the recent U.S. proposals have involved either an RST or a modified subtraction method VAT, which is often packaged as part of a flat tax.²⁹ This is perhaps because of the popularity of the flat tax concept and the familiarity of the U.S. with RSTs.

How does a VAT work?³⁰

As described above, a VAT taxes the value added by each business in the production chain. It can be computed using a “subtraction” method or a “credit invoice” method.³¹

Credit invoice method VATs can resemble RSTs.

From a consumer’s perspective, a credit invoice method VAT can be identical to an RST. Although a VAT is sometimes described as a hidden tax, a credit invoice method VAT could either be broken out on receipts provided to retail customers like a sales tax or hidden like a corporate income tax.³²

Under both an RST and VAT, sales between businesses should not generate a net tax liability. Under an RST, businesses are allowed to make RST-free purchases for resale so that the tax is only imposed on retail sales to consumers. They generally claim this exemption

²⁷ National Health Insurance Act, H.R. 15 (VAT to fund healthcare); Roadmap for America’s Future Act of 2009, S. 1240 (VAT to fund healthcare and other reforms); Simplified, Manageable, and Responsible Tax (SMART) Act, S. 932 (flat tax to replace the income tax); Flat Tax Act of 2009, S. 741 (same); Freedom Flat Tax Act, H.R. 1040 (elective flat tax to replace the income tax); Optional One Page Flat Tax Act, S. 963 (same). For a discussion of other recent bills, see CRS, RL34343, *Tax Reform: An Overview of Proposals in the 110th Congress* (Jan. 2008); CRS, RL33619, *Value-Added Tax: A New U.S. Revenue Source?* (Aug. 2006).

²⁸ See, e.g., Alan Schenk and Oliver Oldman, *Value Added Tax, A Comparative Approach* 41 (Cambridge Univ. Press 2007). A subtraction method VAT was once used by Finland and is being used by the Navaho Nation. See Michael J. McIntyre and Richard D. Pomp, *A Policy Analysis of Michigan’s Mislabeled Gross Receipts Tax*, 53 Wayne L. Rev. 1283, 1296 (Winter 2007). Michigan also employs a tax best described as a subtraction method VAT. *Id.* at 1325.

²⁹ See, e.g., Itai Grinberg, *Implementing a Progressive Consumption Tax: Advantages of Adopting the VAT Credit-Method System*, 59 Nat’l Tax J. 929, 933 (Dec. 2006); Martin A. Sullivan, *Economic Analysis: A Hitchhiker’s Guide to Corporate Tax Reform*, 2009 TNT 232-1 (Dec. 7, 2009); CRS, Report 98-529, *Flat Tax: An Overview of the Hall-Rabushka Proposal* 1 (Feb. 1, 2008) (noting bills sponsored by Representative Michael Burgess, Senator Richard Shelby, and Senator Arlen Specter in the 110th Congress; and by former House Majority Leader Richard Armey in the 107th Congress).

³⁰ Unless otherwise indicated, our description of the VAT is drawn from: Alan Schenk and Oliver Oldman, *Value Added Tax, A Comparative Approach* (Cambridge Univ. Press 2007); ABA Model VAT; GAO Report; Tax Executives Institute (TEI), *Value-Added Taxes, A Comparative Analysis* 113-26 (1992) (hereinafter TEI Report); Joint Committee on Taxation, JCS-18-95, *Description and Analysis of Proposals to Replace the Federal Income Tax* (June 5, 1995) (hereinafter JCT Report); Charles McLure, *The Value-Added Tax: Key to Deficit Reduction?* (American Enterprise Institute for Public Policy Research 1987); American Institute of Certified Public Accountants (AICPA), *Understanding Tax Reform: A Guide to 21st Century Alternatives* (Sept. 2005); AICPA, *Design Issues in a Credit Method Value-Added Tax for the United States* (May 1990); ABA, *A Comprehensive Analysis of Current Consumption Tax Proposals, Chapter 1: A Tax Reform Primer* 7 (1997). For purposes of this analysis we assume that if the U.S. adopted a VAT or RST, the income tax might be reduced but would not be abolished. If the income tax were repealed at the same time, significantly more transition issues would arise. See, e.g., Ronald A. Pearlman, *Transition Issues in Moving to a Consumption Tax*, in *ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM* 393 (Henry Aaron and William Gale, eds., Brookings Institution Press 1996).

³¹ There are other methods for computing VAT, which are beyond the scope of this discussion. See, e.g., Alan Schenk and Oliver Oldman, *Value Added Tax, A Comparative Approach* (Cambridge Univ. Press 2007).

³² See, e.g., AICPA, *Understanding Tax Reform: A Guide to 21st Century Alternatives* 59-52, 66 (Sept. 2005) (noting as a “con” that a credit invoice method VAT could be hidden from consumers and that a subtraction method VAT would be hidden).

by presenting the seller with an exemption certificate.³³ Under a VAT a seller does not need to inquire about the tax status of a purchaser because the seller collects (or at least pays) VAT on every sale, including business-to-business sales. Rather than presenting sellers with exemption certificates, as they do under an RST, purchasing businesses receive tax invoices from sellers and then claim VAT credits directly from the government.

VATs can be computed using a subtraction method.

A VAT can also be computed using a subtraction method. Under the subtraction method, a business cannot claim a credit for VAT shown on its purchase invoices because the tax is not shown on invoices. Instead, a business would deduct or “subtract” allowable purchases (called “input costs” in VAT parlance) from gross receipts to compute “value added,” and then apply the VAT rate to compute the tax (or refund).³⁴

Subtraction method VATs can be “naive” or “sophisticated.”

A so-called “naive” subtraction method VAT allows businesses to deduct input costs even if the purchase was not subject to tax. By contrast, a “sophisticated” subtraction method VAT only allows businesses to deduct input costs associated with taxable purchases.³⁵

Subtraction method VATs can resemble corporate income taxes.

In form, both types of subtraction method VATs resemble a corporate income tax that applies to both incorporated and unincorporated businesses. A VAT (including a credit invoice method VAT) differs from an income tax because capital expenditures are immediately deductible, but employee compensation and interest are typically not taxable or deductible to anyone.³⁶ Rather, employee compensation is indirectly taxed to the extent employees add value to the business’s taxable products or services.

The business component of a flat tax is a modified VAT.

Although perhaps the most notable feature of a flat tax is the flat rate applicable to both individuals and businesses, the business component of a flat tax is a modified subtraction method VAT. Unlike a typical VAT, however, a flat tax allows businesses to deduct wages. It taxes those wages at the same rate as the business tax, after applying a personal exemption. This exemption makes the flat tax somewhat progressive. While we are not aware of any flat tax employing a credit invoice method, such a tax could be devised.

³³ In practice, however, state RSTs do not exempt all business to business sales, leading to double taxation (called cascading), as described below.

³⁴ Although either type of VAT could require returns and payments at any frequency, credit invoice VATs are sometimes described as being “transaction” based, requiring returns and payments more frequently (e.g., monthly rather than yearly) than subtraction method VATs, which are described as “accounts” based.

³⁵ See Charles McLure, *The Value-Added Tax: Key to Deficit Reduction?* 71-102 (American Enterprise Institute for Public Policy Research 1987).

³⁶ Our discussion is limited to consumption-type VATs.

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Examples of VATs and RSTs.

Assume a farmer sells a container of oranges to a processor for \$30, the processor sells orange juice to a restaurant for \$60, and the restaurant sells the juice to retail customers for \$100. The farmer and the processor each add \$30 of value to the product and the restaurant adds \$40 of value. Assuming a 10 percent VAT applies, the farmer and the processor each pay \$3 (\$30 value added x 10 percent tax), the restaurant pays \$4 (\$40 value added x 10 percent tax), and the government collects a total of \$10 (\$3 + \$3 + \$4).

Under a subtraction method VAT, the restaurant subtracts its \$60 in (taxable) purchases from its \$100 in gross receipts and multiplies the resulting \$40 in value added by the 10 percent rate to compute a VAT liability of \$4. Under a credit method VAT, by contrast, the restaurant gets a credit for the VAT paid by the processor, rather than a deduction. The restaurant only gets the credit, however, if it is a registered business and receives an invoice showing the amount of VAT the processor paid in connection with its sale of juice to the restaurant.³⁷ Assuming the restaurant is registered and receives an invoice from the processor showing \$6 in VAT, it could claim this amount as a credit against the \$10 in VAT it will owe on its sale of the juice. After applying this \$6 credit, the restaurant would pay the same \$4 to the government under a credit invoice method VAT.

Under an RST, the government would collect the same \$10, but it would collect the entire amount from the restaurant. Sales by the farmer and processor to other businesses would be exempt.

³⁷ Under a subtraction method VAT, a business might still have to retain expense receipts to claim a deduction. Under the current income tax, the restaurant would also generally need to retain its expense receipts from the processor to be able to deduct its juice purchase. See, e.g., IRC § 6001; Treas. Reg. § 1.6001-1. Under a “sophisticated” subtraction method VAT, however, only taxable purchases from registered businesses would be deductible. The primary difference between such a sophisticated subtraction method VAT and a credit invoice method VAT is that under the subtraction method, the invoice would not reflect the tax paid by the seller.

TABLE 1: Computation of a 10 percent subtraction method VAT, credit invoice method VAT, or retail sales tax.³⁸

Business activity	Farmer	Processor	Restaurant	Total
Taxable sales	\$30	\$60	\$100	
Taxable purchases	(\$0)	(\$30)	(\$60)	
Value added (sales - purchases)	\$30	\$30	\$40	\$100
Subtraction Method VAT				
Tax (10% x value added)	\$3	\$3	\$4	\$10
Credit Method VAT				
Gross tax on sales (10% x sales)	\$3	\$6	\$10	\$19
Less: credit shown on purchase invoices	(\$0)	(\$3)	(\$6)	(\$9)
Net tax	\$3	\$3	\$4	\$10
Retail Sales Tax				
Tax on sales (10% of retail sales)	Exempt	Exempt	\$10	\$10

Credit invoice method VATs can have “exempt” and “zero-rated” sales.**How do exemptions work?**

Under a credit invoice method VAT, unregistered and exempt businesses are treated like final consumers under an RST. They pay VAT charged by suppliers, but do not collect it on sales or claim VAT input credits. VAT laws often provide that small businesses are exempt and do not have to register for VAT or file VAT returns. Unless the exempt business is a retailer, the exemption does not reduce VAT revenue and may *increase* it.

Revenue increases because suppliers pay VAT on sales to exempt businesses that can not claim a credit for it, and upstream businesses later pay VAT on the same value added. This double tax is called “cascading.” In the example above, if the processor were exempt, the restaurant would still pay \$10 of VAT, but nobody could claim an input credit on the taxable purchase from the farmer. Thus, because the portion of the value added by the farmer is taxed twice – once upon the farmer’s sale to the processor and again upon the restaurant’s sale to customers – VAT collected by the government would increase from \$10 to \$13.³⁹

Specific products or services can also be exempt. However, businesses cannot recover input credits for taxable purchases associated with the production of exempt sales. Thus,

³⁸ For simplicity we assume the parties do not purchase any other taxable inputs (except exempt inputs). For purposes of this example, the purchase prices do not include the tax. If an item costs \$100 plus a \$10 RST or credit invoice method VAT charge (i.e., \$110), most people would consider the tax to be levied at a 10 percent rate. This is known as the “tax-exclusive” tax rate. The same tax is also correctly described as being levied at a 9 percent “tax-inclusive” rate, which is computed by dividing the \$10 tax payment by the total cost to the consumer ($\$10/(\$100+\$10) = 9$ percent). Income taxes and subtraction method VATs are typically quoted at tax-inclusive rates. For example, a person that earns \$110 and pays \$10 in income taxes would normally consider the tax to be levied at a 9 percent ($\$10/\110) tax-inclusive rate.

³⁹ Exemptions provide an incentive for vertical integration. For example, the processor could avoid cascading and the additional \$3 tax by purchasing the restaurant, i.e., vertically integrating.

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exemption of final sellers under a credit invoice VAT removes only a portion of the VAT on the final sale to the consumer. Exemptions can also cause complexity and controversy. For example, because certain financial services are often exempt, financial service providers may have to segregate inputs allocable to financial services and inputs allocable to other products and services, as further described below.

How does zero rating work?

In contrast to exemptions, “zero rating” never increases government revenue. Zero-rated sales are subject to tax at a zero percent rate, meaning no tax is collected on sales, but *the seller can still claim any input credits associated with producing the item*. Income tax exempt entities and exports are often zero-rated.

If the restaurant in the previous example were zero-rated, it would not charge VAT on its sales, but could still claim a \$6 input credit for VAT it paid to the processor. As a result, government revenues would decline by the full \$10.

There are special problems with administering exemptions and zero ratings under a subtraction method VAT.

Under a subtraction method VAT, an exempt business would not be taxed on its receipts and could not deduct its input costs. By contrast, while a zero-rated business would not be taxed on its receipts, it could deduct its input costs. Thus, zero-rated businesses would likely receive significant refunds, as they would under a credit invoice method VAT.

Under a subtraction method VAT, however, because a business does not receive invoices reflecting the tax associated with each purchase, the value of business deductions cannot be tied to the amount of tax paid by suppliers. Under a sophisticated subtraction method VAT – one in which businesses could only deduct inputs that had been taxed – businesses might need to ask suppliers for information that would have been provided automatically under a credit invoice method VAT, *i.e.*, whether the purchase was subject to tax.⁴⁰ Even with this information, the value of the deduction might exceed the tax paid by the supplier if more than one VAT rate (including a zero rate) exists. Some have argued that such a system is unworkable.⁴¹

The possibility that refunds could exceed tax revenue is also likely to prompt policymakers to protect revenue by substituting more complex net operating loss carryforwards for

⁴⁰ If suppliers are taxed at different rates, however, the mere indication that an item was subject to tax would not allow the purchaser to compute the amount of tax paid by the supplier. Thus, the value of the purchaser's deduction may exceed (or be less than) the tax paid by the supplier.

⁴¹ See David Weisbach, *Does the X-Tax Mark the Spot?*, U. Chicago L. & Econ., Olin Working Paper No. 163 (Sept. 24, 2002); JCT Report 23 (noting that multiple VAT rates on different items is all but impossible under the subtraction method). However, the GIT, the flat tax proposed by the Tax Reform Panel in 2005, would only have allowed deductions on purchases from businesses subject to the tax. Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* 163 (Nov. 2005). The Japanese VAT allows businesses to deduct purchases from exempt suppliers, but not the purchase of goods or services that are exempt. Alan Schenk and Oliver Oldman, *Value Added Tax, A Comparative Approach* 49, 52 (Cambridge Univ. Press 2007). However, the Japanese VAT has been revised to require businesses to retain more of the information and receipts that would have been provided on credit invoices if they had adopted a credit invoice method VAT. See Alan Schenk, *Japanese Consumption Tax After Six Years: A Unique VAT Matures*, 69 Tax Notes 899, 911 (Nov. 13, 1995).

simple VAT refund mechanisms.⁴² In addition, it is unclear whether or how certain innovative features of a credit invoice method VAT, such as “reverse charges” (described below), could be implemented under a subtraction method VAT.

Credit invoice method VATs can use “reverse charges” to promote compliance and reduce burdens.

A reverse charge is a requirement that the purchaser (rather than the seller) pay the VAT to the government. States with RSTs often apply a kind of reverse charge, called a “use” tax, to consumers who use items within their jurisdiction, if the customer did not pay a sales tax on the purchase. Businesses have a significantly greater incentive to report reverse charges than consumers, however.⁴³ Under a credit invoice method VAT, a business reporting and paying a reverse charge receives VAT input credits, which fully offset the charge. Thus, the purchasing business does not need to come up with funds to make a net VAT payment. By contrast, consumers are not entitled to claim VAT input credits.

Policymakers often use VAT reverse charges to address noncompliance by sellers in sectors that are difficult to tax. For example, some countries use reverse charges to require general construction contractors to pay VAT on the purchase of business services from subcontractors, relieving subcontractors from having to collect and pay VAT when providing services to general contractors.⁴⁴ Other countries apply reverse charges to imported marketing or accounting services, which can sometimes avoid tax because they do not physically cross borders, or to imports of small high-value items, such as cellular phones and computer chips, which can circumvent border controls.⁴⁵

VATs can be complex.

In practice, no broad-based tax is simple and a VAT is no exception.⁴⁶ However, VAT complexity results mostly from tax preferences and other features necessary to address hard-to-tax areas, which are often exempt under an RST. The following discussion highlights a few of these problematic areas.

⁴² See Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* 171 (Nov. 2005) (recommending that exporting firms receive refunds but businesses operating at a loss receive net operating loss carryforwards that would bear interest, along with complicated rules to police the allocation of a single firm's expenses between items produced for domestic sales (which could not generate refunds) and for export sales (which could generate refunds)).

⁴³ For a discussion of some of the EU's challenges with respect to VAT on e-commerce services to consumers, see, e.g., Ba Van Der Merwe, *VAT in the European Union and Electronically Supplied Services to Final Consumers*, 16 S. Afr. Mercantile L.J. 577 (2004).

⁴⁴ See, e.g., Ivan Massin, *Introduction of a General Anti-VAT Avoidance Measure in Belgium*, *International VAT Monitor* 37, 38 (Jan./Feb. 2006) (surveying measures to address VAT avoidance).

⁴⁵ GAO Report 32-33. For example, when a person purchases an imported item in Sweden he or she is sometimes required to pay VAT on the entire purchase price directly to the government rather than the seller. See, e.g., Swedish Tax Agency, *The VAT Brochure* (2009) (discussing “reverse charges”).

⁴⁶ As with any flat tax, however, an RST or VAT would not create marriage or singles penalties or the complex rules needed to address them. For a discussion of these problems, see, e.g., National Taxpayer Advocate 2005 Annual Report to Congress 407 (Key Legislative Recommendation: *Another Marriage Penalty: Taxing the Wrong Spouse*).

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VAT preferences generate complexity, controversy, and burden.

One criticism of the VAT is that it is a regressive tax, meaning that lower-income individuals pay more tax as a percentage of their annual income than higher-income individuals. To counter this regressive nature of the VAT, necessities such as food, health care, housing, and education are often exempt, zero-rated, or subject to special preferential rates. Most VAT commentators agree that it is much simpler and easier to administer a VAT without tax preferences.⁴⁷ Some have argued strongly against such preferences.⁴⁸

First, they argue that VATs (and RSTs) are proportional with respect to income or at least less regressive than they appear when evaluated over a lifetime (rather than annually).⁴⁹ Many households borrow to acquire education, housing, and consumer goods in early years while reporting little income; repay outstanding debts and accumulate savings during middle years while reporting high income; and consume savings during retirement years while reporting low income. This makes a VAT look more regressive when comparing taxpayers with the same lifetime incomes at different ages because the low-earning young and old spend more in relation to their income than the high earners in middle years.⁵⁰ A related argument is that annual consumption may be a better measure of ability to pay than annual income, reducing the importance of progressivity with respect to annual income.

Second, some commentators argue that the burden of a VAT (and presumably an RST) is not always passed along to consumers in the form of higher prices.⁵¹ It is not clear that a VAT would be fully passed along to consumers since other business level taxes (*e.g.*, corporate income taxes) are not.⁵² Research suggests the corporate income tax is likely borne, in

⁴⁷ See, *e.g.*, JCT Report 27.

⁴⁸ See, *e.g.*, David G. Raboy, Consumption Tax Preferential Treatment: Poor Cure for Regressivity, 72 Tax Notes 901 (Aug. 12, 1996).

⁴⁹ See, *e.g.*, Gilbert Metcalf, *Life Cycle Versus Annual Perspectives on the Incidence of a Value Added Tax*, National Bureau of Economic Research 45-64 (Nov. 1993); Don Fullerton and Dianne Rogers, Working Paper No. 3750, *Lifetime vs. Annual Perspectives on Tax Incidence*, National Bureau of Economic Research (June 1991). See also CBO, *Effects of Adopting a Value-Added Tax*, Ch. IV, 43 (Feb. 1992) (noting VATs are less regressive over a lifetime). Some empirical evidence also suggests that the VAT is progressive on an annual basis, in part, because low income persons are more likely to purchase items from the informal economy (*i.e.*, outside the tax system). See, *e.g.*, Glenn Jenkins, et al., *Is the Value Added Tax Naturally Progressive?*, Working Paper No. 1059, Queen's Econ. Dept. (2006).

⁵⁰ The Treasury Department has been studying the possibility of expanding its analysis to take more life cycle effects into account as part of its distributional analysis. See Julie-Anne Cronin, *U.S. Treasury Distributional Analysis Methodology*, OTA Paper 85, 36 (Sept. 1999). For further discussion of problems with distributional analysis, see for example, Leonard E. Burman et al., *Towards a More Consistent Distributional Analysis*, National Tax Association Annual Conference on Taxation (Nov. 18, 2005), http://urbaninstitute.org/UploadedPDF/411480_Towards_Consistent.pdf.

⁵¹ See, *e.g.*, David Raboy, *Value Added Taxes and International Competitiveness*, 10 Tax Notes Int'l 600 (Aug. 28, 1995) (summarizing the debate about VAT incidence); Matthew Haskins, *The Theory and Politics of Tax Integration*, 67 Tax Notes 401 (1995) (same). Moreover, to be accurate any distributional analysis also has to make adjustments to account for flaws in the U.S. consumption data. See generally John Sabelhaus, *What is the Distributional Burden of Taxing Consumption?*, 46 Nat'l Tax J. 331, 342 (Sept. 1993) (identifying data anomalies and concluding that "it is reasonable to infer that existing studies using the residual method to compute saving are biased toward determining that consumption taxes are more regressive than what is probably the case.").

⁵² One recent commentary asserted:

Modern economists in the U.S. take the view that consumers bear only about 50% of the VAT Our own simple general equilibrium model suggests that about 33% of the VAT tax is borne by people in proportion to their relative wage levels, about 17% in proportion to their capital, and about 50% in proportion to their consumption. Ernest S. Christian and Gary A. Robbins, *The Dangers of a Value-Added Tax*, WSJ.com (Oct. 14, 2009).

However, economists that we spoke with did not believe there was any consensus that consumers bear only 50 percent of the VAT.

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part, by shareholders and employees.⁵³ The extent to which a VAT or RST is passed along might vary from item to item.⁵⁴ For some items, businesses might reduce prices so that the after-tax price is roughly the same as before the tax was imposed. Thus, the argument goes, if a portion of a VAT may not be passed along to consumers, there is less need to exempt necessities.

Most importantly, however, commentators agree that exempting necessities is a very costly and inefficient way of benefiting low income consumers. Zero rating food in the U.K. and Canada reduced total VAT revenue collected by 11-12 percent in 2004.⁵⁵ A large portion of the foregone revenue goes to high-income taxpayers who purchase more necessities than lower-income taxpayers. By one 1996 estimate, even assuming any VAT (or VAT savings) would be fully passed along to consumers, exempting food, housing, and health care, would provide over three times the relief to households in the highest income quintile as households in the lowest quintile.⁵⁶ Thus, policymakers could address distributional concerns more efficiently through the income tax code (*e.g.*, by expanding the earned income tax credit or adjusting rates) or by tying VAT revenues to progressive expenditures.⁵⁷

Administrative line-drawing problems also arise in connection with tax preferences. For example, businesses may find themselves litigating over whether dandruff shampoo is a health product entitled to a tax preference if other types of shampoo are not.⁵⁸ The GAO recently observed:

In Canada, basic processories [sic] are zero-rated. Basic processories do not include snacks. Thus, salted peanuts are taxable and plain peanuts are zero-rated. The sale of five or fewer donuts in a single transaction is taxable, but the sale of six or more is zero-rated. In Australia takeout food is taxable if it is served as a single item for consumption away from the place of purchase. However, hot fresh bread is not subject to VAT unless it has sweet filling or coating, or is sold in combination, such as sausage and onion on a slice of bread. Australian and Canadian tax agencies spend resources to maintain lists of processories that fit the definition of zero-rated sales and enforcing these rules.⁵⁹

⁵³ See, *e.g.*, Alan Auerbach, National Bureau of Economic Research Working Paper 11686, *Who Bears the Corporate Tax? A Review of What We Know* (Oct. 2005); William Gentry, Treasury Office of Tax Analysis (OTA) Paper 101, *A Review of the Evidence on the Incidence of the Corporate Income Tax* (Dec. 2007), <http://www.ustreas.gov/offices/tax-policy/library/ota101.pdf>.

⁵⁴ See, *e.g.*, Stephen Entin, Heritage Center for Data Analysis, CDA04-12, *Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?* (Nov. 5, 2004) (illustrating how the “elasticity” of demand and supply for a given product affects the initial incidence of a tax on that product).

⁵⁵ GAO Report 27-28.

⁵⁶ See, *e.g.*, David G. Raboy, *Consumption Tax Preferential Treatment: Poor Cure for Regressivity*, 72 Tax Notes 901, 906-07 (Aug. 12, 1996).

⁵⁷ See, *e.g.*, *Financing Healthcare Reform, Testimony Before the Senate Committee on Finance* (May 12, 2009) (statement of Leonard E. Burman) (suggesting a VAT could fund healthcare reform).

⁵⁸ TEI Report 21 (describing the shampoo controversy).

⁵⁹ GAO Report 27-28.

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From a tax administration perspective, it would obviously be better to avoid preferences, if only to avoid the complexity, controversy, and burden they entail.⁶⁰

Real property typically gets special treatment under a VAT.

Real property is typically subject to special treatment under a VAT. The special treatment favored by some is to tax all real property sales, but to exempt leases and the sale of owner-occupied residences.⁶¹ The European Union Sixth Directive generally exempts leases and sales of real property (including commercial transactions), but taxes the sale of new construction and repairs.⁶² Under the ABA model VAT, the sale or lease of all real property would be subject to VAT, regardless of whether the seller is a business.⁶³ The model would allow a non-business purchaser to take a VAT credit for the purchase of real property, which could not be claimed until the purchaser sold the property. Thus, a person who purchased a home for \$100,000 plus \$10,000 in VAT and later sold it for \$120,000 plus \$12,000 in VAT would remit only \$2,000 in VAT upon selling the property.

Another approach is to provide relief more directly. In Australia, VAT is due on the value of the property added since July 1, 2000 – the date the VAT was introduced.⁶⁴ To offset VAT on new home purchases, the Australian government gave new home buyers a \$6,497 home buyer's grant.⁶⁵

Sales to dealers in used property are often subject to special rules.

The purchase and sale of used goods (*e.g.*, cars, art, furniture, pawn shop inventory, etc.) by registered businesses may be subject to double tax (*i.e.*, cascading) in the absence of special rules. For example, because consumers (and exempt or unregistered businesses) do not collect VAT in connection with sales of used cars to used car dealers, the dealers are not entitled to a credit for the purchase of those cars under a credit invoice method VAT, even if the consumer (or unregistered business) paid VAT on its initial car purchase. As a result, in the absence of special rules, a VAT would cascade with respect to the resale of used cars by used car dealers.

Some countries do not adopt any special rules to address this type of cascading.⁶⁶ In other countries, dealers in used property are exempt.⁶⁷ Another approach is to allow the dealer to claim a credit for the amount of VAT it would have collected if its purchase of used goods

⁶⁰ New Zealand's credit invoice method VAT, which has the broadest base and few exceptions, is generally considered by VAT experts to have the simplest VAT design among the OECD VATs. GAO Report 12.

⁶¹ See, *e.g.*, Sijbren Cnossen, *VAT Treatment of Immovable Property*, in *Tax Law Design and Drafting* 231, 244 (Victor Thuron, ed., IMF, 1996); Alan Schenk and Oliver Oldman, *Value Added Tax, A Comparative Approach* 409-10 (Cambridge Univ. Press 2007) (discussing approaches adopted in Canada and Australia).

⁶² See Recast Sixth Directive, art. 12 and 135.

⁶³ ABA Model VAT 76-77.

⁶⁴ GAO Report 55.

⁶⁵ *Id.*

⁶⁶ See Alan Schenk and Oliver Oldman, *Value Added Tax, A Comparative Approach* 174 (Cambridge Univ. Press 2007) (citing Uganda).

⁶⁷ See TEI Report 24.

were subject to VAT. This is the approach taken by the ABA model VAT and some state sales taxes.⁶⁸ The EU Sixth Directive reaches a similar result by requiring member states to tax only the profit margin (rather than receipts) on the sale of secondhand goods by a taxable dealer.⁶⁹ Each of these measures would add complexity, however.

Financial services are often subject to special rules.

The value added by financial intermediation services, such as lending, brokerage, and insurance services, is often difficult to quantify and tax. This difficulty results because charges for these potentially taxable services are often embedded in markups, interest rates, and insurance premiums, which may not be subject to tax. To address this problem, financial service charges that are not separately stated are often exempt.⁷⁰ Exempting financial services and insurance is a costly solution. The U.K. estimated its exemption of financial services and insurance reduced net VAT revenues by approximately five percent in 2006.⁷¹

Exemptions also create administrative problems. If certain financial services are exempt, financial institutions are not allowed to claim input credits on supplies purchased to produce those financial services. However, if they are allowed to claim input credits with respect to supplies needed to provide other services, they must allocate inputs between exempt and nonexempt outputs. In addition to complexity and recordkeeping burdens, this may lead to tax evasion and controversy when the tax administrator challenges such allocations.

If, instead, a financial service provider is entirely exempt, however, the business has an incentive to acquire suppliers such as cleaning and stationary companies so they can avoid being taxed on input purchases (*e.g.*, stationary supplies and cleaning services) for which they receive no input credits. Such vertical integration has, in turn, prompted some governments to add another layer of complexity by taxing self-supplied goods and services.⁷²

Scholars have recently developed several methods of computing and taxing the value of financial intermediation services.⁷³ The leading methods compute value added based on a

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ABA Model VAT, ch. 5, 104-06.

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Revised Sixth Directive Art. 315.

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See, *e.g.*, Alan Schenk and Oliver Oldman, *Value Added Tax, A Comparative Approach* 304-56 (Cambridge Univ. Press 2007). The ABA committee opposed zero rating or exempting insurance, but it did not provide rules for taxing financial intermediation services because the authors could not agree on a workable method for doing so. ABA Model VAT 169, 173-74.

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GAO Report 24. It is unclear if this estimate takes into account the revenue generated by denying credits for inputs used in financial intermediation services. To avoid the cascading associated with an exemption, the insurance industry in New Zealand supported efforts to include property and casualty premiums in the VAT base, which subjected both premiums and insurance payouts to VAT, but allowed insurers to claim input credits. See, *e.g.*, Richard Bromley, *Flat Taxes, Consumption Taxes, and Value-Added Taxes: Overview and Issues for Insurance Companies*, 10 *Ins. Tax Rev.* 2213 (Jan. 1996).

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See, *e.g.*, Alan Schenk and Howell Zee, *Treating Financial Services Under a Value Added Tax: Conceptual Issues and Country Practices*, 22 *Tax Notes Int'l* 3,309 (June 25, 2001).

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See, *e.g.*, Alan Schenk and Oliver Oldman, *Value Added Tax, A Comparative Approach* 304-56 (Cambridge Univ. Press 2007); Howell H. Zee, *A New Approach to Taxing Financial Intermediation Services Under a Value-Added Tax*, 58 *Nat'l Tax J.* 77-92 (Mar. 2005); Pierre-Pascal Gendron, ITP Paper 0701, *Value-Added Taxes and Financial Services: An Assessment and Policy Proposal for Developing Countries*, Univ. of Toronto (Apr. 2007); Tim Edgar, *The Search for Alternatives to the Exempt Treatment of Financial Services Under a Value Added Tax* (May 25, 2009); Satya Poddar and Morley English, *Taxation of Financial Services Under a Value-Added Tax: Applying the Cash-Flow Approach*, 50 *Nat'l Tax J.* 89-112 (Mar. 1997).

formula, which incorporates cash flows and interest rates. One variation would zero rate business-to-business financial service fees that are not separately stated.⁷⁴ This approach is based on the assumption that any value added by business-to-business financial services would show up in the businesses taxable products or services.

While these approaches are more complicated than a typical VAT computation, financial services businesses are generally sophisticated enough to handle more complex rules. If these methods are simple enough to avoid significant evasion or controversy, they may be preferable to exempting financial services.

Recommendation

As noted above, this report focuses on certain administrative features of VATs and RSTs. Administrability considerations are particularly important because tax design features that reduce complexity, burden, and conflict between taxpayers and the IRS can promote voluntary compliance, potentially allowing the government to raise the same amount revenue at lower rates.⁷⁵ The National Taxpayer Advocate is not taking a position with respect to the imposition of any new tax. However, the National Taxpayer Advocate recommends that policymakers consider the following administrative aspects of RSTs and other VAT-like taxes before deciding to adopt any of them.⁷⁶

1. A credit invoice method VAT may promote voluntary tax compliance better than a comparable subtraction method VAT or RST. Because business buyers claim credits for VAT shown on purchase invoices under a credit invoice method VAT, they have an incentive to ensure that the seller's invoices properly reflect the VAT. If a business's tax liabilities (or credits) are correctly reflected on invoices, tax preparation could involve the simple exercise of adding up the tax (or credit) shown on the invoices. The possibility that the IRS could easily audit these invoices may also discourage under-reporting and minimize opportunities for noncompliance.
2. Establishing only one rate and limiting tax preferences would minimize compliance costs and opportunities for noncompliance. Multiple rates and preferences increase complexity, recordkeeping requirements, compliance costs, tax sheltering opportunities, and disputes about whether transactions qualify for the reduced rate or preference.

⁷⁴ See, e.g., Tim Edgar, *The Search for Alternatives to the Exempt Treatment of Financial Services Under a Value Added Tax* (May 25, 2009) (describing alternatives developed by others).

⁷⁵ Lower rates reduce the incentive for evasion even further. See, e.g., William Gale and Janet Holtzblatt, *The Role of Administrative Issues in Tax Reform: Simplicity, Compliance, and Administration* 8 (Dec. 2000) (citing a number of studies and concluding "the weight of available evidence suggests that lower tax rates reduce evasion rates").

⁷⁶ This analysis does not address the important issue of whether a federal VAT or RST could or should apply to income-tax exempt entities, including federal, state, and local governments. Nor does it address issues associated with transitioning to any new tax. However, policymakers would need to delay the effective date of any new tax to allow businesses and the IRS to put procedures in place to administer it. The administrations in Australia, Canada, and New Zealand took from 15 to 24 months to implement a new VAT. See GAO Report 41.

3. A credit invoice method VAT or RST applicable to imports but not exports (*i.e.*, a “destination-based” tax) reduces the need for complex international tax rules.⁷⁷ A destination-based tax would not require many of the foreign tax credit and transfer pricing rules that are needed under an origin-based tax such as the income tax. Because foreign tax credit and transfer pricing rules are a source of complexity, controversy, and recordkeeping burden, a destination-based tax that did not require them could significantly reduce administrative problems, compliance burdens, and opportunities for noncompliance.
4. At low rates, the administrative costs of an RST may be lower than for a VAT, but a VAT may be less expensive if high rates are needed. Businesses that do not make retail sales are generally not required to file or pay an RST. Under a VAT, however, these businesses would still have to file returns and pay the tax, making a VAT more burdensome for them. As tax rates rise, however, because the revenue lost to noncompliance and correlative enforcement costs and burdens would rise at a faster rate for an RST than for a VAT, these benefits may be more than offset by enforcement costs and burdens.
5. A federal RST or credit invoice method VAT could leverage and accelerate state RST coordination and simplification efforts. To the extent Congress could use the uniform definitions, sourcing rules, forms, and procedures provided by the Streamlined Sales and Use Tax Agreement for a credit invoice method VAT or RST, it would be relatively easy for states to conform their sales and use taxes to the national RST or VAT tax base. Such conformity could provide opportunities to reduce compliance burdens as well as public and private costs to administer both federal and state taxes.

DISCUSSION

A credit invoice method VAT may promote voluntary tax compliance better than a comparable subtraction method VAT or RST.

Empirical evidence regarding VAT and RST compliance is limited.

Estimates of the VAT tax gap – the gap between the amount legally due and timely paid – in various European countries range from 2.4 percent to 34.5 percent.⁷⁸ However, the tax gap is difficult to estimate. According to one set of estimates, the U.K. VAT tax gap ranged from 0.4 percent to 6.5 percent from 1991 to 1993, but official estimates for the same period were over three times higher.⁷⁹ For 2002 to 2007, the U.K. estimates its VAT tax gap ranged between 12.4 and 16.1 percent, which is slightly smaller than the U.S. income tax

⁷⁷ As discussed below, certain subtraction method VATs could not be destination-based without violating trade rules.

⁷⁸ See Michael Keen and Stephen Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?*, 59 Nat'l Tax J. 861, 876 (Dec. 2006).

⁷⁹ See Michael Keen and Stephen Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?*, 59 Nat'l Tax J. 861, 876 (Dec. 2006) (comparing Andrea Gebauer and Rudger Parsche, *Evasion of Value-Added Taxes in Europe: IFO Approach to Estimating the Evasion of Value-Added Taxes on the Basis of National Accounts Data (NAD)*, CESifo DICE Report No. 2, 40-44 (Summer 2003) with U.K. Government, HM Revenue and Customs, *Measuring and Tackling Indirect Tax Losses – 2003* (Dec. 2003)).

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gap of 16.3 percent.⁸⁰ VAT tax gaps in other countries are estimated to be in the ten percent range.⁸¹ Simple VATs at low rates with few preferences are likely to have lower noncompliance rates.

One study estimated the Washington state sales and use tax gaps at 1.3 percent and 27.3 percent, respectively;⁸² another estimated Minnesota's combined sales and use tax gap at about 11 percent.⁸³ State sales tax noncompliance would likely be higher if they were imposed at higher rates. Certain unique credit invoice method VAT design features (described below) may also promote compliance better than typical RSTs.

Credit invoice method VAT rates can climb to higher levels than RSTs before triggering significant noncompliance.

At high levels, a tax may be perceived as unreasonably burdensome, eroding the public's willingness to pay voluntarily. Consider how many people would voluntarily pay a 95 percent income tax.⁸⁴ For this reason, some experts have concluded that a national RST of more than about 10 to 14 percent would probably not be feasible.⁸⁵ One survey found the median U.S. state and local sales tax rate was about five percent, with none exceeding 9.35 percent.⁸⁶ Thus, when combined with state sales taxes in the five percent range, a federal RST of more than about five to ten percent could begin to generate significant compliance problems.⁸⁷

⁸⁰ GAO Report 34; IRS, Tax Gap Map for Year 2001 (Feb. 2007), http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf.

⁸¹ GAO Report 34.

⁸² William Fox and Matthew Murray, *Sales Taxation in a Global Economy*, in *TAXING THE HARD-TO-TAX* 221, 34 (James Alm et al., eds., Elsevier, 2004) (estimating the sales tax gap in Washington state to be 1.3 percent, and the related use tax gap to be 27.9 percent).

⁸³ The 11 percent figure for Minnesota is derived by dividing year 2000 tax gap estimates from a tax gap study (\$451,110,584) by the sum of (1) the tax gap and publicly available data about Minnesota sales and (2) use tax collection in 2000 (\$3.7 billion + \$451,110,584 = \$4.151 billion; \$451,110,584/\$4.151 billion = 11 percent). See Eric Cook et al., American Economics Group, Inc., *Minnesota Sales and Use Tax Gap Project: Final Report* (Nov. 12, 2002) (estimating the 2000 use and sales tax gap at \$451,110,584); Minnesota Revenue, *Minnesota's Sales and Use Tax, Overview* (2005) (indicating Minnesota's sales and use tax raised \$3.7 billion in fiscal year 2000).

⁸⁴ See, e.g., Tamás K. Papp and El d Takáts, *Tax Rate Cuts and Tax Compliance – The Laffer Curve Revisited*, IMF Working Paper No. 08/7 (Jan. 2008) (concluding that at some levels of tax an income tax cut could increase revenue by reducing evasion).

⁸⁵ See, e.g., ABA Model VAT ch. 1, 3 (1989) (“[t]he Canadian Royal Commission on Taxation has estimated this point [beyond which RST evasion becomes a problem] at 14 percent.”); Alan A. Tait, *VALUE-ADDED TAX: INTERNATIONAL PRACTICE AND PROBLEMS* 18 (International Monetary Fund, 1988) (observing: “At 5 percent, the incentive to evade [an RST] is probably not worth the penalties of prosecution, at 10 percent, evasion is more attractive, and at 15-20 percent, becomes extremely tempting.”); Vito Tanzi, *TAXATION IN AN INTEGRATING WORLD* (The Brookings Institution 1995) (concluding “10 percent may well be the maximum rate feasible under an RST”); Charles McLure, *THE VALUE-ADDED TAX: KEY TO DEFICIT REDUCTION?* 107 (American Enterprise Institute 1987) (concluding that “at rates higher than about 10 percent the enforcement and efficiency advantages of the VAT probably outweigh the advantages of the retail sales tax”). See also George R. Zodrow, *The Sales Tax, the VAT, and Taxes in Between – or, Is the Only Good NRST a “VAT in Drag”?* 52 *Nat'l Tax J.* 429, 431 (Sept. 1999).

⁸⁶ William Fox and Matthew Murray, *Sales Taxation in a Global Economy*, in *TAXING THE HARD-TO-TAX* 221, 224 (James Alm et al., eds., Elsevier, 2004).

⁸⁷ Treasury Department Report to the President, *Tax Reform, Fairness, Simplicity, and Economic Growth*, vol. 1, ch. 3, 34-35 (Nov. 1984) (“A Federal retail sales tax, when combined with the retail sales taxes levied by most states, would provide an irresistible inducement to tax evasion at the retail level. By comparison, the VAT would involve collection of about two-thirds of revenue before the retail stage. Moreover, a VAT would contain self-enforcement features that, while easily overstated, are quite important.”).

By contrast, research suggests that VAT rates can increase to about 20 or 25 percent before noncompliance diminishes VAT revenue.⁸⁸ One survey found that about two thirds of the VATs levied by OECD member countries were between 15 and 22 percent.⁸⁹ The relatively higher rates that could be imposed using a VAT are likely due to features of a credit invoice method VAT that promote compliance. These features may also allow a credit invoice method VAT to have a broader base that includes more difficult-to-tax sectors. If so, a VAT might be able to generate more revenue at lower rates than an RST.

Unique credit invoice method VAT design features promote compliance.

VATs expand third party withholding.

As explained above, manufacturers and wholesalers essentially withhold a portion of the tax for retailers by paying VAT to the government that retailers can later claim as a credit. IRS research confirms that withholding and information reporting are extremely important in promoting tax compliance. Taxpayers report more than 98 percent of all income subject to third party information reporting and withholding, as compared to less than 50 percent of all income not subject to information reporting or withholding.⁹⁰ Thus, the reporting and withholding associated with a VAT should have a positive effect on compliance.

VATs rely more on upstream producers and less on retailers than RSTs.

The withholding associated with a VAT also reduces the revenue lost with each unreported sale in the same way that wage withholding reduces the income tax revenue lost when a wage earner does not ultimately file an income tax return. For example, if the restaurant in the above example did not report its sale, VAT revenue would decline from \$10 to \$6, rather than by the entire \$10, unless the restaurant also claimed a \$6 input credit on its input purchase, which the IRS should be more likely to detect.

By contrast, an RST attempts to collect tax on the entire value added at the final retail sale, which is often made by small businesses that are less likely to have internal controls than

⁸⁸ See, e.g., Ali Agha and Jonathan Houghton, *Designing VAT Systems: Some Efficiency Considerations*, *Review of Economics and Statistics* 303-08 (May 1996) (estimating that a one percentage point increase in the VAT rate from the sample average of 15.8 percent would reduce the compliance rate by 2.7 percentage points, and suggesting that the revenue maximizing VAT rate may be less than 25 percent because of increased evasion resulting at higher rates); Kent Matthews and Jean Lloyd-Williams, *Have VAT Rates Reached Their Limit? An Empirical Note* 7, *Applied Econ. Letters* 111-15 (Feb. 2000) (suggesting the revenue maximizing VAT rate is about 20 percent). At the same time, some have concluded that it might not be worth introducing a VAT with a rate of less than five percent. Charles McLure, *THE VALUE-ADDED TAX: KEY TO DEFICIT REDUCTION?* 23 (American Enterprise Institute 1987) (explaining that the administrative costs of a five percent broad based VAT would constitute less than one percent of revenues, which is comparable to the income tax, but at a VAT rate of two percent these costs would consume two to three percent of revenues).

⁸⁹ OECD, *Consumption Tax Trends* 46 (2008).

⁹⁰ See IRS, *Tax Gap Map for Year 2001* (Feb. 2007). Other IRS research confirms the value of prepayments. One study found that taxpayers who owe a balance upon filing their returns are more likely to understate their tax liability than other taxpayers. Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters* 7 (Jan. 16, 2004).

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larger upstream suppliers that would be charged with collecting a VAT.⁹¹ Small businesses that underreport income are responsible for the largest component of the federal income tax gap.⁹² As a result, it may be problematic to rely on this sector to remit tax attributable to value added by them and their suppliers as is the case under an RST. Because a VAT collects significantly more revenue before the retail sale than an RST, only a small fraction of a VAT is avoided when retailers do not report retail sales. This VAT feature should reduce both the motive for, and revenue lost to, underreporting at the retail level.

Market-based incentives promote accurate credit invoices.

Unlike an RST, a credit invoice method VAT creates conflicting incentives that may prevent buyers and sellers from colluding to produce inaccurate invoices. Buyers have an incentive to overstate the purchase price to inflate input credits, while sellers have an incentive to understate it to reduce output taxes. For this reason a credit invoice method VAT is sometimes said to be “self enforcing.”⁹³ This is an important benefit, but it may be somewhat overstated. As with an RST, these positive incentives do not extend to purchases by final consumers who do not get any credit for the VAT shown on invoices.

Credit invoice method VATs facilitate matching and audits.

Once the amount of VAT is self-reported on an invoice, inadvertent errors should decline.⁹⁴ In addition, detecting noncompliance becomes much easier. The mere possibility that the IRS could crosscheck invoices lodged in a third party's files (*i.e.*, the purchaser's invoice, which shows the amount of tax the seller was required to pay) is likely to discourage noncompliance. In addition, at some point in the future, automated matching and cross-checking may become feasible, especially as electronic invoices become the norm, thereby reducing opportunities for noncompliance.

In the meantime, tax administrators could develop sales-to-VAT ratios for each industry and create automated processes that flag suspicious VAT returns. In France, approximately

⁹¹ See, e.g., George R. Zodrow, *The Sales Tax, the VAT, and Taxes in Between – or, Is the Only Good NRST a “VAT in Drag”?*, 52 Nat'l Tax J. 429-42 (Sept. 1999); Michael Keen and Stephen Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?*, 59 Nat'l Tax J. 861-88 (Dec. 2006). When Congress changed the point of taxation for the diesel fuel excise tax from the wholesaler/distributor to the terminal, it reduced the number of filers and curtailed tax evasion, increasing revenue collections by 58.5 percent. See Statement of Margaret Milner Richardson, Commissioner of Internal Revenue, Before the Subcommittee on Oversight Committee on Ways and Means, *reprinted* as Richardson's Testimony at W&M Oversight Hearing on Tax Refund Fraud, 94 TNT 193-33 (Sept. 29, 1994).

⁹² See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress vol. 2 (*A Comprehensive Strategy for Addressing the Cash Economy*); SB/SE Research, *Strategic Assessment FY 2009-FY 2010*, 22-25 (Feb. 2008).

⁹³ See Michael Keen and Stephen Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?*, 59 Nat'l Tax J. 861, 865 (Dec. 2006) (describing the “self enforcing” characterization by VAT advocates).

⁹⁴ The desire to avoid a VAT combined with an unwillingness to falsify invoices or claim VAT credits from the government, however, could cause groups of business to operate in the cash economy – outside the VAT system. But, a VAT could reduce the number of unregistered businesses operating in the cash economy because only registered businesses can claim input credits and registered business customers generally prefer to deal with registered businesses so that it is easier for them to compute their input credits, as noted below. Australia sought to leverage this effect when it introduced a VAT by requiring payors to withhold on payments to businesses that did not provide a tax registration number that could be verified, but compliance gains have been difficult to measure. See, e.g., Christopher Bajada, *Recent Government Initiatives in Tackling the Underground Economy in Australia*, in *SIZE, CAUSES AND CONSEQUENCES OF THE UNDERGROUND ECONOMY: AN INTERNATIONAL PERSPECTIVE*, 243-72 (Christopher Bajada and Friedrich Schneider, eds., Ashgate Publishing Ltd. 2005).

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88 percent of the VAT returns identified as risky and audited are ultimately reassessed.⁹⁵ Once a business is identified as potentially noncompliant, a review of invoices should make it relatively easy for auditors to identify unpaid tax. Federal VAT invoices and audits could also yield information that would help the IRS identify income tax underreporting, potentially reducing the income tax gap.⁹⁶ No similar audit trail or incentives exists under an RST or a subtraction method VAT.

Credit invoice method VATs provide market-based incentives for sellers to register.

Under a credit invoice method VAT, registered businesses have an incentive to purchase inputs only from other registered businesses. As noted above, they can only claim VAT credits on purchases from registered suppliers. In the absence of more than one VAT rate, if a business obtains inputs only from registered businesses that collect VAT, the business can also compute its input credits, in large part, by multiplying its costs of goods sold by the VAT rate. This may reduce compliance burdens.

If large businesses prefer to deal with registered suppliers, then suppliers have an incentive to register and collect VAT, even if they are not legally required to do so. Registered businesses are also entitled to claim VAT credits. Perhaps for these reasons, over 30 percent of the registered businesses in Australia and Canada registered voluntarily even though they had sales below the registration thresholds (\$75,000 and \$30,000 respectively).⁹⁷ Some small businesses may also register to conceal the small size of their operations from customers.

A subtraction method VAT would not necessarily establish the same incentives unless the deductibility of inputs hinged on the taxability of the supplier (or supplies). Such a “sophisticated” subtraction method VAT, however, would require a seller to reliably communicate its tax status and the tax status of the items being sold to the buyer – the same information that could easily be communicated by listing the tax (if any) due in connection with the transaction on an invoice under the credit invoice method VAT. Moreover, because the tax liability would not be shown on any invoice, a subtraction method VAT would not provide as clear of an audit trail.

⁹⁵ GAO Report 29.

⁹⁶ A pilot program pursuant to which the IRS uses state sales tax data to select income tax returns for audit has enabled it to identify returns that are less likely to result in no changes (*i.e.*, lower no-change rates) and more likely to yield higher dollars per hour than returns selected using the IRS’s DIF program – its state-of-the-art computer algorithm. IRS response to TAS information request (May 19, 2009).

⁹⁷ GAO Report 29.

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Under a credit invoice method VAT, noncompliance does not always reduce government revenue.

The government does not lose any revenue when business suppliers operate outside a VAT tax system, unless they make domestic retail sales.⁹⁸ Any value added by these businesses is taxed when incorporated into other products or services ultimately purchased by domestic consumers in taxable transactions. In the example above, assume the farmer did not collect VAT on his sale of oranges. Because the processor would not be entitled to VAT credit for its orange purchase, its net VAT liability would increase by \$3 – the same amount the farmer was required to pay. Thus, government revenue would not decline.

VATs may be perceived as more “fair” than RSTs that cascade.

By some accounts, VATs solve “one of the most vexing administrative problems of a retail sales tax” by eliminating the need for businesses to present a resale exemption certificate to avoid cascading.⁹⁹ State sales tax exemptions generally only apply to property purchased for resale or incorporated into property the sale of which is subject to tax.¹⁰⁰ For example, some states apply an RST to electricity used by manufacturers to produce products that will also be subject to the RST.¹⁰¹ By one estimate, approximately 44 percent of state sales taxes are collected on intermediate goods, thus resulting in double taxation.¹⁰²

Such cascading can produce tax administration and collection problems if it promotes the view that the tax is unfair.¹⁰³ One proposal would reduce sales tax cascading by allowing businesses to apply for refunds of RST paid on inputs, just like they could under a VAT.¹⁰⁴ Policymakers contemplating an RST may wish to consider such innovations, but the introduction of frequent refunds may raise the same concerns about refund fraud that exist under a VAT.

⁹⁸ A VAT or RST would also be charged on sales to businesses operating in the underground economy, including those participating in organized crime and assumed to be operating outside the tax system. Some commentators discount this as a benefit, however, because even a corporate income tax could be passed along by businesses to customers participating in the underground economy to the same extent as a VAT or RST. Moreover, underground economy businesses are unlikely to collect or pay VAT or RST on their retail sales.

⁹⁹ AICPA, *Understanding Tax Reform: A Guide to 21st Century Alternatives* 47 (Sept. 2005).

¹⁰⁰ JCT Report 47.

¹⁰¹ See, e.g., N.C. Gen. Stat. § 105-164.4(a)(1f) (West 2009).

¹⁰² See Andrew Phillips et al., *Total State and Local Business Taxes: 50-State Estimates for Fiscal 2007*, 48 *State Tax Notes* 471 (May 12, 2008). See also Raymond Ring, *Consumers' Share and Producers' Share of the General Sales Tax*, 52 *Nat'l Tax J.* 79-90 (Mar. 1999) (estimating the consumer share of sales taxes at 59 percent, leaving 41 percent as the business share). For additional discussion of this problem, see Robert Cline et al., *Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Services*, 2005 *STT* 29-1 (Jan. 28, 2005).

¹⁰³ See, e.g., Richard Lavoie, *Cultivating a Compliance Culture: An Alternative Approach for Addressing the Tax Gap*, U. of Akron Legal Studies Research Paper No. 08-05, 5-7 (Sept. 1, 2008) (explaining that “[s]ince the deterrence model fails to accurately predict tax evasion levels, other forces must be influencing citizens to comply despite the apparently overwhelming economic utility of cheating. The hodgepodge of non-coercive forces and behavioral traits that influence the degree of tax evasion are generally referred to under the umbrella rubric of a society's tax morale.”); National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 138 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*) (describing various research findings regarding the effect of personal values, social norms and tax morale on taxpayer compliance).

¹⁰⁴ See George R. Zodrow, *The Sales Tax, the VAT, and Taxes in Between – or, Is the Only Good NRST a “VAT in Drag”?*, 52 *Nat'l Tax J.* 429, 431 (Sept. 1999), citing Peter Mieszkowski and Michael Palumbo, *Is a National Retail Sales Tax Administrable? A Proposal for a Hybrid NRST* (1999) (manuscript).

VATs are susceptible to refund fraud.

All taxes are susceptible to fraud and a VAT is no exception. In the case of a VAT or RST, such fraud may include: (1) failing to register; (2) underreporting sales (*e.g.*, by not reporting cash sales, diverting items for consumption by employees or owners of the business, or underreporting the value of related party sales); (3) misclassifying sales as those subject to lower rates if more than one rate is available (*e.g.*, reporting taxable domestic sales as zero rated exports); (4) collecting tax but not remitting it, for example, by going bankrupt or disappearing (called missing trader fraud).¹⁰⁵

Because a VAT generally depends on input credits (or deductions) that give rise to refunds, it is also susceptible to refund fraud. One report estimated that VAT refunds constitute 40 to 50 percent of gross VAT collections among typical EU countries, and 10 to 20 percent in Africa, Asia, and Latin America, with variations depending largely on the level of exports and extent to which zero rating is used.¹⁰⁶

If some items are exempt from VAT, a business may improperly claim VAT credits (or deductions) by over-allocating inputs to taxable outputs (for which the input credit or deduction is available) and under-allocating inputs to exempt outputs (for which the input credit or deduction is unavailable). Alternatively, a business may generate false invoices solely to generate fraudulent VAT credits or deductions. These basic problems have many variations.¹⁰⁷ The European Commission has stated that up to ten percent of VAT receipts have reportedly been lost to fraud in some member states.¹⁰⁸

Exploitation of zero-rated exports is particularly problematic in countries that pay rapid VAT credits and do not collect VAT on imports at the border.¹⁰⁹ Because the full value of any import (rather than just the value added by the importer) is taxed at the border, more tax is at stake when imports escape taxation than when a single business in the domestic production chain does so. In 1984, the Treasury Department suggested that the U.S. Customs Service could collect a U.S. VAT on imports at the border.¹¹⁰ Thus, the relatively few land borders between the U.S. and other countries combined with good VAT design could mean that refund fraud attributable to reimportation (*i.e.*, claiming credits on items supposedly exported but actually reimported or otherwise diverted to domestic consumers) might be less of a problem in the U.S. than in many EU countries. Moreover, refundable credits are not inherently problematic – it's all in the design.¹¹¹

¹⁰⁵ See, *e.g.*, Michael Keen and Stephen Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?*, 59 Nat'l Tax J. 861-88 (Dec. 2006); GAO Report 9.

¹⁰⁶ See Graham Harrison and Russell Krelove, IMF Working Paper No. 05/218, *VAT Refunds: A Review of Country Experience* (2005).

¹⁰⁷ See, *e.g.*, Michael Keen and Stephen Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?*, 59 Nat'l Tax J. 861, 866-68 (Dec. 2006).

¹⁰⁸ European Commission, *EU Coherent Strategy Against Fiscal Fraud – Frequently Asked Questions*, MEMO/06/221 (May 31, 2006).

¹⁰⁹ See generally Michael Keen and Stephen Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?*, 59 Nat'l Tax J. 861, 870 (Dec. 2006).

¹¹⁰ See Treasury Department Report to the President, *Tax Reform, Fairness, Simplicity, and Economic Growth*, vol. 3, ch. 9, 113-17 (Nov. 1984). Australia and New Zealand have programs that allow businesses with an established compliance history to defer VAT payments on imports, paying in regular intervals, rather than on a per shipment basis. GAO Report 32. The U.S. could consider a similar approach.

¹¹¹ For a discussion of how income tax credits should be structured, see *Running Social Programs Through the Tax System*, *infra*.

Good VAT design could minimize fraud.**Offset VAT credits against other tax liabilities before paying refunds.**

There are a wide variety of ways to reduce refund fraud, but many are overly burdensome or complicated. For example, some countries (1) delay refunds until after a VAT audit; (2) require VAT credits to first offset the person's liability for VAT or other taxes for the current period or a specified number of future periods before paying any refund; (3) delay any refund until after the purchaser has paid the entire purchase price of the asset for which the credit is claimed; (4) require businesses to carry VAT credits forward (indefinitely or for a limited period) before refunding them;¹¹² or (5) pay VAT refunds in bonds, which could be offset in the case of fraud, rather than in cash.¹¹³

The 2005 Tax Reform Panel recommended allowing refunds only with respect to exports.¹¹⁴ Other losses would only generate net operating loss carryforwards. The panel likely took this bifurcated approach because VAT refunds cannot be denied to exporters without significantly impeding business operations. Because exporters may never have sufficient taxable receipts to absorb the VAT deductions or credits generated by zero-rated exports, only those with profitable domestic sales would have been able to use loss carryforwards.¹¹⁵ However, the bifurcated approach would increase the incentive to misallocate deductions or credits associated with domestic sales to exports.

By contrast, the ABA Model VAT recommended treating VAT credits as an overpayment of tax and would allow businesses to elect to have the credits offset other tax liabilities so they could be utilized more rapidly.¹¹⁶ This approach of simply offsetting VAT credits against outstanding tax liabilities might help reduce net VAT refunds without unduly burdening taxpayers, especially if combined with other strategies (described below) to address refund fraud.

Expedite VAT refunds to compliant taxpayers; review large refunds; deny them to noncompliant taxpayers.

Governments can reduce the risk of VAT fraud if they allow tax administrators sufficient time to verify the validity of VAT refunds before paying them. The U.S. government currently reviews the propriety of large income tax refund requests.¹¹⁷ However, such requests are more infrequent than they would be under a VAT and delays are costly for businesses. In the countries recently reviewed by the GAO, tax administrators were generally required

¹¹² The EU's Sixth Directive requires member states to either make a refund or carry excess credits forward to the next period. Recast Sixth Directive, art. 183.

¹¹³ See, e.g., Alan Schenk and Oliver Oldman, *Value Added Tax, A Comparative Approach* 167-70 (Cambridge Univ. Press 2007).

¹¹⁴ See Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* 171 (Nov. 2005).

¹¹⁵ While loss carryforwards are theoretically feasible for domestic businesses, they frequently go unused under the income tax as well. See, e.g., Michael Cooper and Matthew Knittel, *Partial Loss Refundability: How Are Corporate Tax Losses Used?*, 59 Nat'l Tax J. 651-63 (Sept. 2006) (estimating that approximately 25-30 percent are never used). Thus, loss carryforwards may be a relatively complicated and inefficient method of returning VAT credits.

¹¹⁶ ABA Model VAT ch 5, at 98.

¹¹⁷ See IRC § 6405.

to compensate businesses for such delays by paying interest on VAT refunds that are not paid within a standard period, which ranged from 14 to 21 days.¹¹⁸

Some have also suggested that paying refunds more quickly to businesses with a history of tax compliance and also those that obtain a guarantor could minimize the delays needed to prevent fraud.¹¹⁹ Others would deny refunds to those that have recently committed fraud.¹²⁰

Use reverse charges and systems that can implement real-time matching.

Other approaches to minimize the payment of improper refunds to exporters include the use of reverse charges (described above) or computerized information exchange systems. For example, the EU imposes reverse charges on intra-EU imports. In other words, VAT is paid by the domestic purchasing business that is generally claiming an offsetting input credit, rather than by the foreign seller.¹²¹ The EU also requires exporters to electronically verify that their customers are registered with the tax administrator in the importing country.¹²² This system could allow the tax administrator for the exporting country to automatically determine if the importer paid any tax due on the import before paying refunds of input credits (called border tax adjustments) to the exporter.¹²³ However, such systems may depend, at least in part, on cooperation by foreign tax agencies.

Under a simple credit invoice method VAT, reporting compliance gains could overshadow refund fraud losses.

While refund fraud must be taken seriously, a dollar lost to underreporting or underpayment is just as costly for the government as a dollar lost to refund fraud. Moreover, far more taxpayers are likely to be willing to underreport or underpay an RST, or make a tax-free sale, than would be willing to engage in outright fraud by claiming an improper credit or refund directly from the government. Thus, the other features of a credit invoice method VAT that promote improved compliance would likely outweigh concerns about

¹¹⁸ GAO, GAO-08-566, *Value-Added Taxes, Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden and Transition* 17 (Apr. 2008).

¹¹⁹ See, e.g., Michael Keen and Stephen Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?*, 59 Nat'l Tax J. 861, 879, 881 (Dec. 2006).

¹²⁰ Under the Eighth Council Directive, persons found to have committed refund fraud can be denied refund credits for the later of two years or until they pay the penalty for fraud. Eighth Council Directive, *On the Harmonization of the Laws of the Member States Relating to Turnover Taxes – Arrangements for the Refund of Value Added Tax to Taxable Persons Not Established in the Territory of the Country*, art. 7 (Dec. 6, 1979).

¹²¹ The domestic purchaser pays VAT to the government rather than to the foreign seller on its input costs. If the purchaser can claim an input credit on the purchase, the credit can offset the VAT due on the purchase. As illustrated above, input credits can normally result in refunds or offset VAT due on taxable sales. However, if the credit is used to offset the VAT due on an input purchase, it cannot generate refunds or offset VAT due on the purchaser's taxable sales.

¹²² The EU has a system called the VAT Information Exchange System (VIES) for use by exporters to other EU countries. See http://ec.europa.eu/taxation_customs/taxation/vat/traders/vat_number/index_en.htm.

¹²³ Because of the lags involved, VIES reportedly does not always allow tax administrators to verify that import taxes were paid before paying out refunds to exporters. Michael Keen and Stephen Smith, *VAT Fraud and Evasion: What Do We Know and What Can Be Done?*, 59 Nat'l Tax J. 861, 880 n.22 (Dec. 2006). However, because the system will eventually detect irregularities, it probably discourages noncompliance. One option could be to delay refund payments until the system verifies that import taxes were actually paid.

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refund fraud, at least if the tax has few preferences and is designed to limit the potential for refund fraud.

The risk of refund fraud is also present under a subtraction method VAT, but it does not have some of the beneficial features of a credit invoice method VAT that would promote reporting compliance. For example, under a subtraction method VAT, no invoice would allow the IRS to match the buyer’s VAT credit to the seller’s VAT payment.

While there is less danger of refund fraud under an RST than a VAT, an RST relies more heavily on small business retailers, which account for a significant portion of the income tax gap.¹²⁴ Moreover, RSTs are generally imposed on a narrower base, thus, requiring higher rates to raise the same amount of revenue. Higher rates would provide additional incentives for noncompliance, tilting the scales in favor of a VAT if the RST rate would need to exceed about ten percent, at least according to one expert.¹²⁵

Establishing only one rate and limiting tax preferences would minimize compliance costs and noncompliance.

Tax preferences including multiple rates increase costs and reduce compliance.

As described above, tax preferences increase noncompliance as well as the costs of tax compliance and administration.¹²⁶ Some have suggested that complexity could increase the cost of the VAT examination program by 30 to 50 percent.¹²⁷ One study estimated that each distinct VAT rate would reduce compliance by seven percentage points, and that a one percentage point increase in the VAT rate from the sample average of 15.8 percent would reduce the compliance rate by 2.7 percentage points.¹²⁸ As with the income tax, preferences can also reduce transparency, making it more difficult for taxpayers to compute their effective tax rate. A well-designed VAT, therefore, avoids tax preferences, especially the application of exemptions or special rates to specific items.

¹²⁴ See, e.g., National Taxpayer Advocate 2007 Annual Report to Congress vol. 2 (*A Comprehensive Strategy for Addressing the Cash Economy*); SB/SE Research, *Strategic Assessment FY 2009-FY 2010*, 22-25 (Feb. 2008).

¹²⁵ See, e.g., Charles McLure, *The Value-Added Tax: Key to Deficit Reduction?* 107 (American Enterprise Institute for Public Policy Research 1987) (concluding, in part, that at rates higher than about ten percent enforcement advantages of a VAT outweigh an RST, and because half of the states have RSTs of at least five percent (three quarters of the states if local taxes are included), the choice should probably be a VAT).

¹²⁶ According to one estimate, compliance costs borne by both the government and taxpayers eat up 10 percent of U.S. income tax revenue, between 2.4 and 4.8 percent of sales tax revenue, between 3 and 5 percent of VAT revenue. Joel Slemrod, *Which Is the Simplest Tax System of All?* in *ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM* 355, 368-69, 373-74 (Henry Aaron and William Gale, eds., Brookings Institution Press 1996) (summarizing other studies; observing that variations in compliance costs are attributable to the complexity and preferences typically associated with each tax, and that the RST compliance cost estimate may not be comparable to other taxes because imposing an RST at the higher rates typically associated with VATs and income taxes would significantly increase evasion and associated compliance costs as a percentage of revenue).

¹²⁷ See GAO, GAO/GGD-93-78, *Value-Added Tax: Administrative Costs Vary with Complexity and Number of Businesses* 7 (May 1993).

¹²⁸ See Ali Agha and Jonathan Haughton, *Designing Vat Systems: Some Efficiency Considerations*, 78 Rev. Econ. Stat. 303-08 (May 1996).

VAT preferences and complexity may prompt lawmakers to exempt small businesses and others.

Estimates of the VAT compliance burden range from approximately two percent of revenue for businesses with less than \$50,000 in sales to 0.04 percent for those with over \$1 million in sales.¹²⁹ Thus, VAT compliance costs may fall disproportionately on small businesses.

One common way to address VAT compliance burdens and administrative costs is to exempt small businesses from VAT altogether. According to one study, an exemption that reduced the number of businesses subject to the tax by 63 percent (from 24 million to 9 million) would reduce the VAT revenue base by less than three percent.¹³⁰

However, a high small business exemption threshold could complicate coordination of a federal VAT with state RSTs, as described below, and distort competition with slightly larger businesses. More importantly, a high exemption threshold may not significantly reduce small business burdens because many already collect RST or are likely to register for the VAT voluntarily. Moreover, exemptions can increase overall compliance costs for other businesses that need to segregate exempt purchases from taxable ones to compute their deductions or credits, particularly if the purchaser does not receive credit invoices (*e.g.*, under a sophisticated subtraction method VAT).

Policymakers could reduce small business compliance burdens in other ways.

Cash flow benefits, tax credits, and less frequent filing requirements could also reduce or offset small business VAT compliance burdens. The cash flow benefits of holding VAT collected from customers that is not yet due to be paid to the government may provide a significant benefit to businesses. The value of this benefit has been estimated to offset the overall gross compliance burden by almost 40 percent.¹³¹ Allowing businesses to hold VAT collections for long periods of time before paying them over to the government, however, increases the risk that those funds will not be paid over at all.¹³²

Another option might be to authorize payment card companies to act as intermediaries for businesses. If the VAT were simple enough and had so few preferences that payment card companies could determine which transactions were taxable and at what rate, they could automatically deduct VAT from payment card receipts and pay it over to the government on behalf of the business. They could also claim VAT credits from the government on behalf of businesses that make taxable (creditable) purchases with a payment card.¹³³ We are

¹²⁹ GAO Report 16.

¹³⁰ GAO, GAO/GGD-93-78, *Value-Added Tax: Administrative Costs Vary with Complexity and Number of Businesses* 3-4 (May 1993).

¹³¹ GAO Report 17.

¹³² According to IRS research, taxpayers who owe a balance upon filing a return are more likely to understate their tax liability than other taxpayers and more than 20 percent of such taxpayers with a balance due fail to pay it in full. Wage and Investment Division, Research Group 5, Project No. 5-03-06-2-028N, *Experimental Tests of Remedial Actions to Reduce Insufficient Prepayments: Effectiveness of 2002 Letters 1-7* (Jan. 16, 2004).

¹³³ This program could build on the qualified payment card agent (QPCA) program, which allows payment card companies to satisfy information reporting obligations for both the payee and payor. See, *e.g.*, Treas. Reg. § 31.3406(j)-1; Notice 2007-59, 2007-30 I.R.B. 135.

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not aware of any jurisdiction using such a “paperless” VAT system. This could be due to the fact that most national VATs were implemented before payment cards became as prevalent as they are today. If it were feasible, however, a paperless system could significantly reduce the administrative burdens of a VAT for both taxpayers and the IRS.¹³⁴

Tax credits have also been used to help small businesses with VAT implementation costs. In Australia, the government gave small businesses tax credits worth \$186 to help them purchase equipment to facilitate initial VAT implementation.¹³⁵ Canadian businesses received one-time credits of up to \$1,159.¹³⁶

Another option is to allow small businesses to file less frequently and to use more flexible accounting methods. Large businesses are often required to file and remit VAT monthly, but small businesses often have the option to file and remit VAT less frequently, such as quarterly or annually, reducing VAT compliance costs.¹³⁷ Some tax administrators also allow small businesses to use modified accounting methods to calculate their net VAT due for a given period based on payment dates, the invoice dates, or a combination of both.¹³⁸

In addition, small businesses are sometimes given the option to pay a reduced VAT rate on retail sales based on the average industry markup in lieu of claiming input credits.¹³⁹ Another variation of this approach would allow small businesses to compute their input credits by adding up expenses for inputs (including those not subject to VAT or subject to lower VAT rates) and applying a fixed rate, rather than having to sum each input credit shown on an invoice.¹⁴⁰ These options could be considered as ways to reduce small business compliance costs, but the potential for complexity and confusion may outweigh the benefits of these approaches. As noted above, the tax law should provide some choices, but not too many choices. Too many choices can result in a complicated system that entraps taxpayers or does not minimize opportunities for noncompliance.

A subtraction method VAT could make preferences more difficult to administer.
Because exemptions and multiple rates are regarded as undesirable, some view the inflexibility of a subtraction method VAT in accommodating them as a positive feature.¹⁴¹ For

¹³⁴ To the extent such a system encouraged businesses to accept payment cards in lieu of cash, it could also reduce income tax underreporting attributable to the cash economy. However, any additional tax also increases the incentive for businesses to operate in cash and outside the tax system.

¹³⁵ GAO Report 42.

¹³⁶ GAO Report 44.

¹³⁷ GAO Report 30.

¹³⁸ GAO Report 31-32. Similar accommodations are available under the income tax. For example, small businesses are generally allowed to use the cash method of income tax accounting. See generally IRC § 448.

¹³⁹ See, e.g., HMRC Notice 733 (Mar. 2007); Alan Schenk and Oliver Oldman, *Value Added Tax, A Comparative Approach* 178 (Cambridge Univ. Press 2007); Canada Revenue Agency, RC4070(e), *Guide for Canadian Small Businesses* 21-22 (2008) (describing the “quick method” for claiming input tax credits).

¹⁴⁰ Canada Revenue Agency, RC4070(e), *Guide for Canadian Small Businesses* 21-22 (2008) (describing the “simplified method” for claiming input tax credits).

¹⁴¹ See, e.g., TEI Report 25. Multiple VAT rates on different items are all but impossible under the subtraction method. See, e.g., JCT Report 23. From a purely administrative perspective, if a subtraction method VAT were adopted, the corporate income tax might also seem redundant because the administrative and compliance burdens of both taxes would overlap to a significant extent.

example, it would be burdensome to require businesses to segregate different types of receipts and expenses and then apply more than one rate without invoices that reflect the tax associated with each transaction. Others argue, however, that given the possibility that such complexity will be adopted, it is better to have systems in place – such as those provided by a credit invoice method – to collect the information taxpayers will need to comply with the law.¹⁴² Indeed, in 1987 Canada considered and rejected a subtraction method VAT, in part, because it was viewed as a less practical alternative for administering exemptions and multiple rates.¹⁴³

Moreover, a subtraction method VAT would not necessarily be immune to exemptions and preferences. Under the U.S. corporate income tax, which is collected in a similar manner, capital expenditures are generally recovered over time instead of being deductible. But, some capital expenses are nevertheless deductible (affording them preferential treatment), and some receipts are taxed at preferential rates (*e.g.*, receipts from domestic production activities or those earned by small corporations with income below the amount subject to the top marginal rates).¹⁴⁴ Similarly complicated preferences could be enacted under a subtraction method VAT, but they would be more difficult to administer without the benefit of credit invoices.¹⁴⁵

A credit invoice method VAT or RST applicable to imports but not exports (*i.e.*, a “destination-based” tax) reduces the need for complex international tax rules.

Most VATs imposed around the world are destination-based, meaning they apply to all goods and services destined for consumers in the taxing jurisdiction, regardless of where they originate.¹⁴⁶ Under a destination-based credit invoice method VAT, exporters receive a refund for tax paid on inputs and the export is not subject to tax (*i.e.*, exports are zero-rated). Imports are taxed at the border. The net tax refunds or payments associated with imports and exports are called “border tax adjustments” or BTAs.

Under a destination-based system, both domestic and foreign businesses providing goods and services to U.S. consumers would be subject to tax at the same U.S. VAT rate. Similarly, given the prevalence of destination-based VATs overseas, goods and services provided to foreign consumers by U.S. and foreign businesses would be taxed at the same foreign VAT rate.

¹⁴² See, *e.g.*, David Weisbach, *Does the X-Tax Mark the Spot?*, U. Chicago L. & Econ., Olin Working Paper No. 163 (Sept. 24, 2002).

¹⁴³ TEI Report 102.

¹⁴⁴ See generally IRC §§ 167, 168, 199.

¹⁴⁵ In 1989, the American Bar Association adopted a resolution that if Congress imposes a VAT it should (1) employ the “credit method” rather than the “subtraction method,” and (2) levy the tax at a uniform rate, with a zero rate for exports and certain necessities, and as few exemptions as possible. ABA, *House of Delegates Resolution on Value Added Tax*, 1986-1 ABA Repts. 301 (Feb. 11, 1986). In 1999, the Tax Section recommended revoking the 1989 resolution because the 1989 policy explicitly mentioned only two systems and “could be interpreted to prohibit comments on other systems.” ABA, Section of Taxation, *Report to the House of Delegates* (Feb. 1999), www.abanet.org/tax/pubpolicy/1999/vat99.html.

¹⁴⁶ See, *e.g.*, Keith Kendall, *Using Destination and Origin Principles in Developing VAT Legislation*, 42 Tax Notes Int’l 983 (June 12, 2006); Alan Schenk and Oliver Oldman, *Value Added Tax, A Comparative Approach* 182 (Cambridge Univ. Press 2007).

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By contrast, under an origin-based tax, goods and services originating in the U.S. would be subject to tax in the U.S. regardless of where they are consumed. Without special rules, exports would be taxed in the U.S. and also in a foreign jurisdiction.

Origin-based VATs may foster complexity and provide opportunities for noncompliance.

An origin-based VAT could subject U.S. exports to double taxation unless it was coupled with a system of foreign tax credits to reimburse the exporter for taxes paid abroad.¹⁴⁷ In addition, as with the current origin-based U.S. income tax, an origin-based VAT would require complicated transfer pricing rules.¹⁴⁸ These rules would be needed to keep businesses from understating their domestic taxable receipts from domestic production by paying artificially high prices to affiliated foreign suppliers, thereby shifting taxable receipts overseas where they would not be subject to the U.S. tax.

By contrast, under a destination-based VAT, any tax lost as a result of below market sales among affiliates at intermediate stages of production is recovered in connection with the final arms-length sale to U.S. consumers, potentially reducing any such concerns. For these reasons, among others, some tax experts believe that origin-based taxes are also more susceptible to tax avoidance schemes.¹⁴⁹

Others have suggested that origin-based taxes might be easier to administer when taxing jurisdictions have few border controls because taxpayers can avoid destination-based taxes if imports are not taxed immediately (*i.e.*, at the border).¹⁵⁰ As noted above, however, because of the relative geographic isolation of the United States, tax avoidance through VAT-free importation may be less of a problem.

Destination-based taxes establish a transparently level international playing field.

Some argue that countries with a destination-based VAT have a competitive advantage because exports generate tax credits while imports are subject to the tax.¹⁵¹ The competitive

¹⁴⁷ U.S. taxpayers can obtain foreign tax credits (FTCs) against U.S. income tax for income tax paid to foreign countries. See IRC § 901, *et seq.* They cannot obtain FTCs for VAT paid to foreign countries because VATs are considered “indirect” taxes that are really borne by the buyer rather than the seller who is generating taxable income in the U.S. Some have disputed this premise and suggested U.S. taxpayers should also get income tax credits for indirect taxes, such as foreign VATs. See, e.g., Reuven S. Avi-Yonah, *A Creditable VAT?*, 114 Tax Notes 793 (Feb. 19, 2007); Andres Bazo Pisani, *Should the U.S. Allow Foreign Tax Credits for the VAT?*, 51 Tax Notes Int’l 341 (July 28, 2008).

¹⁴⁸ See, e.g., Report of the President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System* 167-72 (Nov. 2005).

¹⁴⁹ See, e.g., Report of the President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System* 167-72 (Nov. 2005) (providing an example of one such scheme); David Weisbach, *Does the X-Tax Mark the Spot?*, U. Chicago L. & Econ., Olin Working Paper No. 163 (Sept. 24, 2002).

¹⁵⁰ When the EU first proposed tax harmonization, it was expected the origin principle could be applied to intra-community trade while the destination principle would continue to apply to extra-community trade, but the origin principle was ultimately abandoned. See, e.g., TEI Report 100-01.

¹⁵¹ See, e.g., David Hartman, *The Case for Border-Adjusted Taxation in the United States*, 35 Tax Notes Int’l 1183 (Sept. 27, 2004).

advantages of giving exporters hefty tax refunds (*i.e.*, BTAs), while imposing a tax on importers seems obvious, at least in the short run.¹⁵²

In the long run, exchange rates and input prices are theoretically supposed to adjust to offset any apparent competitive advantages.¹⁵³ In practice, such adjustments could be delayed or even derailed by currency manipulation, uneven application of the tax (*e.g.*, tax preferences), or other unanticipated factors.¹⁵⁴ Even if a destination-based VAT has no long-term effect on trade, it has the benefit of being a simple way to transparently level the playing field for domestic businesses. They do not have to trust that invisible exchange rate and price adjustments will eventually do so. Thus, aside from the broader policy implications of the choice between destination- and origin-based taxation, a transparent and fair destination-based tax may have a clear administrative advantage – voluntary compliance may be higher if the tax is perceived to be fair.

Certain subtraction method VATs could not be destination-based without violating trade rules.

The U.S. might be charged with violating international trade rules if it adopted a destination-based flat tax or similar subtraction method VAT with border tax adjustments (BTAs). BTAs are prohibited for “direct” taxes, but are permitted for “indirect” taxes.¹⁵⁵ A direct tax includes a tax “on wages, profits ...and all other forms of income,” while an indirect tax includes “sales, excise, turnover, value added ...and all taxes other than direct taxes.”¹⁵⁶ BTAs are also prohibited if “in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.”¹⁵⁷ Some have argued that a progressive subtraction method VAT (*e.g.*, a flat tax) could not be implemented with BTAs because of its (1) similarity to an income tax (*i.e.*, a direct tax), and (2) lack of a mechanism

¹⁵² See, *e.g.*, Joint Committee on Taxation, JCX-23-02, *Background Materials on Business Tax Issues Prepared for the House Committee on Ways and Means Tax Policy Discussion Series 70* (Apr. 4, 2002) (noting: “In the short term, destination-principle consumption taxes are thought to be economically superior to origin-principle consumption taxes...”). Some economists, however, would disagree.

¹⁵³ See, *e.g.*, David Raboy, *Value Added Taxes and International Competitiveness*, 10 Tax Notes Int'l 600 (Aug. 28, 1995) (summarizing the debate); Paul Krugman and Martin S. Feldstein, *International Trade Effects of Value Added Taxation*, NBER Working Paper No. W3163 (Nov. 1989). Some empirical evidence suggests that a destination-based VAT may not give domestic businesses a competitive advantage even in the short run. See Michael Keen and Murtaza Syed, *Domestic Taxes and International Trade: Some Evidence*, IMF Working Paper (Feb. 2006); Mihir Desai and James Hines Jr., *Value-Added Taxes and International Trade: The Evidence*, Harvard Business School (2002).

¹⁵⁴ As used in this discussion, “currency manipulation” means that a foreign central bank sets currency exchange rates so as to keep the U.S. dollar artificially high and its own currency artificially low in order to gain an unfair trade advantage by making its country's products cheaper in the U.S. as compared to U.S.-produced products. For a recent analysis of the complicated economic effects of currency manipulation, see Robert W. Staiger and Alan O. Sykes, Working Paper 14600, “*Currency Manipulation and World Trade*,” National Bureau of Economic Research (Dec. 2008).

¹⁵⁵ See Article 1.1(a)(1)(2) and Annex I (e)-(h) of the World Trade Organization Agreement on Subsidies and Countervailing Measures, 33 I.L.M. 1125 (1994) (hereinafter SCM). Academics have also argued that some types of consumption taxes, such as the flat tax or USA tax, which are progressive subtraction method VATs could be “direct” taxes that would have to be “apportioned” among the states pursuant to the fourth Clause of Article I, Section 2, of the U.S. Constitution or “laid ... in Proportion to the Census,” as required by Section 9 of Article I. See Erik Jensen, *The Apportionment of “Direct Taxes”: Are Consumption Taxes Constitutional?*, 97 Colum. L. Rev. 2334 (Dec. 1997). Others have countered that these direct tax limitations should be interpreted narrowly. See Bruce Ackerman, *Taxation and the Constitution*, 99 Colum. L. Rev. 1 (Jan. 1999). Income taxes are direct taxes, but do not have to be apportioned because of the Sixteenth Amendment. *Id.*

¹⁵⁶ SCM n.58.

¹⁵⁷ SCM Annex I(g).

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to prevent BTAs paid on exports from exceeding the tax levied on similar products sold into the domestic market.¹⁵⁸

The first argument – that a subtraction method VAT is a direct tax because it looks like an income tax and thus could not utilize BTAs – is difficult to assess because it is based on form rather than substance. The form of a subtraction method VAT does not clearly require it to be categorized as either a direct or indirect tax. However, a naive subtraction method VAT (*e.g.*, one permitting deductions for inputs that were not subject to tax) could violate the second rule by paying excessive BTAs to exporters. For example, an exporter would be entitled to deduct supplies purchased from exempt or zero-rated suppliers.¹⁵⁹ Thus, the BTAs received by exporters under a naive subtraction method VAT could exceed the VAT paid by suppliers. As a result, BTAs paid on exports could exceed the tax levied on the same items sold into the domestic market from abroad. This might be deemed a violation of the rules.

A sophisticated subtraction method VAT with multiple rates could also produce excessive BTAs. It would allow a business to fully deduct the cost of inputs acquired in taxable transactions, even if the value added by its suppliers (or their suppliers) was subject to tax at a reduced rate (potentially including the zero rate). As a result, even a sophisticated subtraction method VAT could face challenges if implemented with BTAs. A sophisticated subtraction method VAT with BTAs might avoid producing excessive BTAs if it were implemented with a single rate and permitted deductions only for expenses acquired in transactions subject to tax at that single rate. However, it might still be subject to challenge if it is deemed a “direct” tax.

At low rates, the administrative costs of an RST may be lower than for a VAT, but a VAT may be less costly if high rates are needed.

According to one estimate, the compliance costs borne by both the government and taxpayers amount to 10 percent of U.S. income tax revenue, between 2.4 and 4.8 percent of RST revenue, and between 3 and 5 percent of VAT revenue.¹⁶⁰ The authors of this estimate argue, however, that the RST estimate may not be comparable to other taxes because imposing an RST at the higher rates typically associated with VATs and income taxes would significantly increase evasion and associated compliance costs as a percentage of revenue.

¹⁵⁸ See, *e.g.*, Itai Grinberg, *Implementing a Progressive Consumption Tax: Advantages of Adopting the VAT Credit-Method System*, 59 *Nat'l Tax J.* 929-30 (Dec. 2006); David Weisbach, *Does the X-Tax Mark the Spot?*, U. Chicago L. & Econ., Olin Working Paper No. 163 (Sept. 24, 2002). Japan's three percent destination-based subtraction method VAT was not subject claims of illegality, perhaps because it was not progressive. See, *e.g.*, TEI Report 112. However, some have suggested that even a plain subtraction method VAT (*i.e.*, one without a business deduction for wages) could be subject to claims of illegality. See JCT Report 28, *citing* George Carlson and Richard Gordon, *VAT or Business Transfer Tax: A Tax on Consumers or on Businesses?*, 41 *Tax Notes* 329 (Oct. 17, 1988). Others have suggested that a subtraction method VAT could legally include BTAs based solely on the “political power of the United States and the argument that these taxes are equivalent to border-adjustable, credit invoice VATs.” Martin A. Sullivan, *Economic Analysis: A Hitchhiker's Guide to Corporate Tax Reform*, 2009 TNT 232-1 (Dec. 7, 2009).

¹⁵⁹ See, *e.g.*, Charles McLure, *The Value-Added Tax: Key to Deficit Reduction?* 79-81 (American Enterprise Institute for Public Policy Research 1987).

¹⁶⁰ Joel Slemrod, *Which Is the Simplest Tax System of All?* in *ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM* 355, 368-69, 373-74 (Henry Aaron and William Gale, eds., Brookings Institution Press 1996) (summarizing other studies).

Nonetheless, at low rates, these estimates suggest that compliance costs would be lower (as a percentage of revenue) for an RST than for a VAT, and significantly lower than for the income tax.

A VAT would generate more returns than an RST.

The compliance costs for a VAT would be higher for a VAT than for an RST because a VAT requires more taxpayers to file returns (*i.e.*, taxpayers that do not make retail sales). However, a VAT would require fewer additional returns than one might assume. By one estimate, an RST would involve only about ten percent fewer firms than a VAT because many business suppliers also make retail sales.¹⁶¹ Moreover, returns filed by business-to-business suppliers create incentives (described above) that make a VAT less prone to cascading and noncompliance than an RST.

A credit invoice method VAT would not necessarily entail significantly more recordkeeping than a subtraction method VAT.

As noted above, a business can only claim a VAT credit under the credit invoice method if it is registered and receives invoices showing VAT paid by suppliers. While the production and retention of such invoices is burdensome, in many cases, businesses already have to retain invoices to substantiate income tax deductions. Moreover, they would probably need to retain records containing much of the same information if a sophisticated subtraction method VAT were adopted.¹⁶² As a result, the additional invoice-related burden associated with adopting a credit invoice method VAT as compared to a subtraction method VAT might be relatively small. The additional burden might consist, primarily, of modifying billing and accounting systems to enable them to reflect the VAT and the seller's VAT registration number. As noted above, other countries have offset these transition costs by allowing a one-time credit for any such modifications.

¹⁶¹ Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth*, vol. 3, ch. 4, 32 (1984) (explaining that "[t]he reason the difference is not greater is because a retail sales tax is not confined exclusively to retailers. Nonretail firms making retail sales must also register for the tax. Moreover, even firms making tax-free purchases, and no retail sales, must be checked by auditors to verify that the purchases were for exempt uses.").

¹⁶² The Japanese subtraction method VAT has been revised to require businesses to retain more information and receipts that would have been provided on credit invoices if they had adopted a credit invoice method VAT. See Alan Schenk, *Japanese Consumption Tax After Six Years: A Unique VAT Matures*, 69 *Tax Notes* 899, 911 (Nov. 13, 1995). The Tax Reform Panel's GiT provides "that deductible purchases be allowed only from businesses that are subject to the tax, and that these purchases be substantiated." Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* ch. 7, 163 (Nov. 2005).

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A federal RST or credit invoice method VAT could leverage and accelerate state RST coordination and simplification efforts.

Multi-state groups have been working to coordinate and simplify state sales tax rules for over a decade.

Since 1967, U.S. Supreme Court precedent has barred states from requiring out-of-state mail order sellers to collect use tax in the absence of federal authorization.¹⁶³ The burden of requiring them to collect a wide variety of nonconforming taxes in thousands of local jurisdictions violates the Commerce Clause.¹⁶⁴ Thus, only businesses with an in-state physical presence were required to collect the tax. Federal law also prohibits a state from imposing a tax on the net income derived from in-state sales of businesses whose only activity within the state is the solicitation of orders for the sale of tangible personal property filled from out-of-state.¹⁶⁵ As a result, state revenues shrank and main-street retailers argued that out-of-state mail order vendors had a competitive advantage, prompting states to seek ways to both reduce sales tax complexity and level the playing field.

For at least the last 12 years, the Streamlined Sales and Use Tax Project (SSTP) and predecessor groups have been working to produce the Streamlined Sales and Use Tax Agreement (SSUTA), which would simplify and coordinate state sales and use tax laws to reduce the multi-state tax compliance burden.¹⁶⁶ Once state laws are coordinated, the Commerce Clause might not prohibit the states from requiring out-of-state mail order vendors (and service providers) to collect local use taxes. Even if it does, however, Congress could authorize the states to require out-of-state sellers to collect local use taxes.

Although the states have not agreed on a uniform RST base, SSUTA requires one rate to be imposed per state, and establishes uniform definitions (*e.g.*, product and service definitions), sourcing rules for determining which state's tax applies, multi-state forms, and

¹⁶³ See *National Bellas Hess, Inc. v. Dept. of Revenue*, 386 U.S. 753 (1967) (holding that a state law violated the Due Process Clause and the Commerce Clause by imposing liability on an out-of-state mail order firm to collect use taxes due from in-state customers where the mail order firm had no in-state physical presence); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (affirming the *Bella Hess* Commerce Clause holding, but reversing the Due Process clause holding because the remote sellers purposefully availed themselves of the benefits provided by the state). Because Congress has the power to regulate interstate commerce, it could authorize the states to require mail order sellers to collect state use tax. *Id.* at 318. Destination-based sales taxes do not apply to goods shipped to out-of-state customers. In such cases the customer is often subject to a "use" tax in his or her state of residence, but states use a reverse charge mechanism (*i.e.*, having businesses collect use taxes) because consumers often fail to pay them. Because states cannot currently require out-of-state businesses to do so, they provide incentives for them to agree to do so, as described below.

¹⁶⁴ See *id.*

¹⁶⁵ Pub. L. No. 86-272 (1959) (codified at 15 U.S.C. §§ 381-384). In response to federal limitations, many states have enacted a wide variety of gross receipts taxes and business activity taxes not directly based on net income, and interpreted the reach of their taxes (including nexus and corporate income tax apportionment formulas) expansively with complicated and inconsistent results that can tax a single item more than once or not at all. Report of the Task Force on Business Activity Taxes and Nexus of the ABA Section of Taxation State and Local Taxes Committee, 62 Tax Law. 935, 963-83 (Summer 2009) (hereinafter the ABA BAT Report). States generally oppose legislation that would clarify and extend Pub. L. No. 86-272 to services and intangible property transactions. See National Governors Association, *Impact of H.R. 1956, Business Activity Tax Simplification Act of 2005, on States* (Sept. 26, 2005). Faced with this situation, some multi-state businesses have reportedly given up on complying with inconsistent state tax apportionment rules, figuring it is easier to wait for an audit. ABA BAT Report 975-77.

¹⁶⁶ For a helpful discussion of this process, see John Swain and Walter Hellerstein, *The Political Economy of the Streamlined Sales and Use Tax Agreement*, 58 Nat'l Tax J. 605-19 (Sept. 2005).

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procedures. It also provides incentives for businesses to voluntarily collect local use taxes. Twenty-two states have adopted conforming changes to their sales tax laws.¹⁶⁷

A national VAT or RST could leverage and accelerate state simplification efforts.

A national RST or VAT could leverage the simplification achieved by SSUTA. To the extent Congress could use the SSUTA definitions, sourcing rules, forms, and procedures for a credit invoice method VAT or RST, it would be relatively easy for states to conform their sales and use taxes to the national RST or VAT tax base (assuming such conformity were authorized under federal law). Even if the states did not all conform, common definitions and sourcing rules could significantly reduce the marginal compliance burden associated with both state and national RSTs or VATs.¹⁶⁸

Because a federal credit invoice method VAT would be nearly identical to an RST at the retail level, simplification and conformity could be achieved with either.¹⁶⁹ For example, in Argentina, Brazil, and Canada, state or provincial sales taxes are administered alongside a national VAT.¹⁷⁰ Three Canadian provinces abolished provincial RST systems and created a harmonized sales tax, administered by the federal government, when Canada adopted a VAT.¹⁷¹

Congress could provide additional incentives for states to conform to the federal tax base. For example, it could offer to authorize states to require out-of-state mail order vendors to collect use tax.¹⁷² It could offer to collect state taxes, which could be added to

¹⁶⁷ SSUTP, *White Paper on Streamlining State Sales Taxes* (2009). Those 22 states are: Arkansas, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, and Wyoming. *Id.* Conforming legislation has been introduced in Texas, Massachusetts, Florida, Illinois, and Hawaii. *Id.* As of 2004, Alaska, Delaware, New Hampshire, Montana and Oregon did not levy general sales taxes. See William Fox and Matthew Murray, *Sales Taxation in a Global Economy*, in *TAXING THE HARD-TO-TAX* 221, 223 (James Alm et al., eds., Elsevier 2004).

¹⁶⁸ In the event that the states adopted destination-based VATs, they would need a mechanism for collecting VAT on interstate sales in the absence of interstate border controls. See, e.g., Charles McLure, *Coordinating State Sales Taxes with a Federal VAT: Opportunities, Risks, and Challenges*, Symposium on Federal Tax Reform and the States 13 n.31 (May 15, 2005) (citing to methods called “VIVAT,” “CVAT,” and “PVAT”). One possibility would be to have the seller collect the state VAT at the rate imposed in the purchaser’s state (as states would prefer with respect to the use tax) and then allow purchasing businesses to claim a corresponding input credit. Sellers could similarly collect a use tax on sales into states that retained an RST, except that VAT-registered businesses could be exempt.

¹⁶⁹ According to one expert, “it would seem quite difficult to coordinate state sales taxes with ... the ‘naive’ version of a subtraction method VAT.” Charles McLure, *Coordinating State Sales Taxes with a Federal VAT: Opportunities, Risks, and Challenges*, Symposium on Federal Tax Reform and the States 1 n.2 (May 15, 2005).

¹⁷⁰ GAO Report 35.

¹⁷¹ GAO Report 39. Similarly, Australia replaced inefficient sub-national sales taxes with a federal VAT. *Id.* at 35-36. The federal government in Australia collects the VAT and distributes the revenue to Australian states and territories. *Id.* The states and territories reimburse the federal government for the costs incurred to administer it. *Id.*

¹⁷² The Sales Tax Fairness and Simplification Act (H.R. 3396 and S. 34) would do so. For a description of this and related legislation, see CRS, RL 33261, *Internet Taxation: Issues and Legislation* (July 7, 2008). By one estimate, state revenue loss for 2012 will be in the \$11.4 billion to \$12.65 billion range. See Donald Bruce and William Fox, *State and Local Sales Tax Revenue Losses from E-Commerce*, Transaction Tax Standards Association (Apr. 8, 2009), <http://www.t2sa.org/book/export/html/142>. But see Annette Nellen, *California’s Use Tax Collection Challenges and Possible Remedies*, Calif. Tax Lawyer 25, 27 (Fall 2007) (describing a number of other estimates for different years).

An Analysis of Tax Administration Issues Raised by a Consumption Tax,
Such as a National Sales Tax or Value Added Tax

federal forms.¹⁷³ It could pay a small percentage of the federal tax to conforming states.¹⁷⁴ Conformity with a broader federal tax base might allow the states to simplify their laws and lower rates. It could also facilitate joint federal and state audits and information sharing that could improve compliance, which could in turn, fund further rate reductions.

State level coordination and simplification would be easier with fewer federal preferences.

The Canadian system demonstrates that a federal VAT can coexist with provincial RSTs and VATs that are either coordinated or uncoordinated.¹⁷⁵ However, state conformity with a federal VAT or RST would be easier if the federal tax did not provide a significant number of exemptions, such as the small business exemption, which are not typically available under state RSTs.¹⁷⁶ Conformity would reduce the marginal compliance and administrative burdens associated with any new federal tax, potentially even reducing the overall compliance burdens faced by businesses currently subject to multi-state RST filing obligations, especially if coordinated filing and payment procedures were adopted.

A federal VAT could replace state RSTs.

Another way to achieve conformity might be to replace state RSTs with a federal VAT, the proceeds of which could be distributed back to the states. For example, Australia replaced inefficient sub-national sales taxes with a federal VAT.¹⁷⁷ The federal government in Australia collects the VAT and distributes the revenue to Australian states and territories.¹⁷⁸ A similar arrangement could be considered for the U.S., if it could be structured so as not to unduly impinge state sovereignty.

¹⁷³ In Canada, the national revenue agency collects the sales tax on behalf of some provinces, and one province collects both the provincial and federal VAT. For a discussion of Canada's experience in enacting a national VAT while harmonizing provincial sales taxes, see, e.g., Richard Bird, et al., *Coordinating Federal and Provincial Sales Taxes: Lessons from the Canadian Experience*, ITP Paper (Nov. 2006).

¹⁷⁴ The Fair Tax Act of 2003, H.R. 25, and similar legislation would allow the states to administer a national sales tax in exchange for one percent of total collections.

¹⁷⁵ Some Canadian provinces have coordinated sales taxes, while others have uncoordinated sales taxes, and one province has its own uncoordinated VAT. For an interesting discussion of how Canada's VAT system evolved, see Richard M. Bird and Pierre-Pascal Gendron, *Sales Taxes in Canada: The GST-HST-QST-RST "System"* (May 29, 2009), <http://ssrn.com/abstract=1413333>.

¹⁷⁶ For further discussion of this issue, see Charles McLure, *Coordinating State Sales Taxes with a Federal VAT: Opportunities, Risks, and Challenges*, Symposium on Federal Tax Reform and the States (May 15, 2005). Businesses registered for the federal VAT could be treated as having an RST exemption certificate. *Id.* They could be listed in a federal database just like the IRS's current TIN matching program which allows taxpayers to validate name/TIN combinations before filing a return. See Treas. Reg. § 31.3406(j)-1; Notice 2007-59, 2007-30 I.R.B. 135.

¹⁷⁷ GAO Report at 35-36.

¹⁷⁸ *Id.*

CONCLUSION

At combined federal and state rates below about ten percent, experts have concluded that the administrative costs and burdens associated with a federal RST may be lower than for a VAT, but that a VAT may be less costly and burdensome if higher rates are needed. Moreover, a VAT is less dependent on compliance by those businesses – often small businesses – making the final sale to consumers. If a VAT is needed, a credit invoice method VAT probably does a better job of minimizing opportunities for noncompliance than a subtraction method VAT (or an RST) because business buyers have an incentive to ensure that the seller invoices properly reflect the VAT. If the seller's tax liabilities (or credits) are correctly reflected on invoices, tax preparation could involve adding up the tax (or credit) shown on the invoices. The possibility that the IRS could easily audit these invoices may discourage underreporting.

Minimizing special VAT rates, exemptions, and preferences would also help to minimize VAT complexity, reduce compliance costs, opportunities for noncompliance, tax sheltering opportunities, and disputes about whether transactions qualify for the reduced rate or preference. In addition, a credit invoice method VAT could be simpler than a subtraction method VAT because it could be structured as a destination-based tax that would not require complex international tax rules.¹⁷⁹ It might also be easier to coordinate with state RSTs. Any progress a new federal VAT or RST could make in coordinating and simplifying state sales or income taxes without unduly impinging state sovereignty could potentially reduce complexity and burden, especially for multi-state businesses.

¹⁷⁹ As discussed above, certain subtraction method VATs could not be destination-based without violating trade rules.

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**RUNNING SOCIAL PROGRAMS
THROUGH THE TAX SYSTEM**

Running Social Programs Through the Tax System¹

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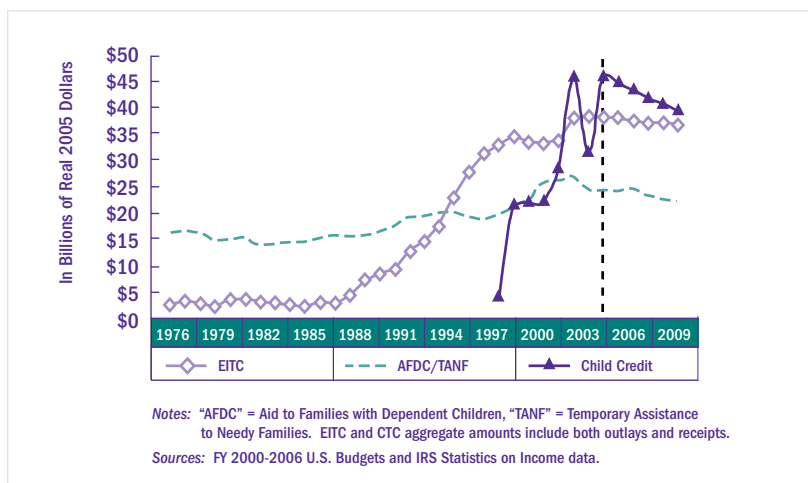
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Running Social Programs Through the Tax System

INTRODUCTION

The passage of the American Recovery and Reinvestment Tax Act of 2009 (ARRA) and the Worker, Homeownership, and Business Assistance Act of 2009 (WHBA) demonstrates that Congress views refundable tax credits as a favored means of delivering social benefits and implementing policy.² The Congressional Budget Office has estimated that refundable credits will increase by approximately \$500 billion over the next ten years.³ The chart below, created by the Tax Policy Center, illustrates the dramatic increase in federal spending on two refundable credits (the Earned Income Tax Credit (EITC) and Child Tax Credit (CTC)) compared to welfare (Aid to Families with Dependent Children / Temporary Assistance for Needy Families (AFDC/TANF)), a direct spending program, since 1976:⁴

FIGURE 1: Real Federal Spending on the EITC, Child Credit, and Welfare (AFDC/TANF), Fiscal Year (FY) 1976-2010



² Pub. L. No. 111-5, Division B, 123 Stat. 306 (2009); Pub. L. No. 111-92, 123 Stat. 2984, § 11(Nov. 6, 2009).

³ Doug Elmendorf, Congressional Budget Office, *Federal Budget Challenges* (Apr. 20, 2009), available at <http://www.cbo.gov/ftpdocs/100xx/doc10093/04-20-Harvard.pdf> (last visited Oct. 16, 2009).

⁴ Tax Policy Center, *Tax Facts*, available at http://www.taxpolicycenter.org/taxfacts/Content/PDF/eitc_child_historical.pdf (last visited Oct. 16, 2009). Social programs and refundable credits are not limited to low income individuals. For example, ARRA expanded the Work Opportunity Tax Credit, a tax incentive for businesses to hire workers belonging to any of 12 targeted groups. Pub. L. No. 111-5, Division B, § 1221, 123 Stat. 306 (2009). ARRA also created new tax incentives for certain taxable governmental bonds (Build America Bonds and Recovery Zone Economic Development Bonds) whereby the governmental issuer of such bonds may elect (in lieu of issuing tax-exempt bonds) to receive a direct refundable credit payment from the federal government, equal to a percentage of the interest payments on these bonds. Pub. L. No. 111-5, Division B, § 1531, 123 Stat. 306 (2009).

BACKGROUND

Tax Expenditure vs. Direct Spending Program

A government can distribute social benefits through either a direct spending program or a tax expenditure. Direct spending programs require an appropriation with specific dollar amounts, while tax expenditures can be viewed as benefit distribution programs channeled through the tax system. Another important difference between the two systems is that taxpayers generally declare their own eligibility before receiving the benefits.⁵ In contrast, many direct spending programs such as food stamps and TANF include a bureaucratic determination of eligibility before releasing the benefit payments.⁶

Tax expenditures take a variety of forms:

- Exclusions, exemptions, and deductions, which reduce taxable income;
- Preferential tax rates, which apply lower rates to part or all of the taxable income;
- Tax credits, which can be refundable or nonrefundable. The former can create a refund greater than the amount of tax due, whereas the latter is limited to the amount of tax due; and
- Deferrals of tax, which result from delayed recognition of income or from claiming deductions in the current year for expenses attributable to a future year.⁷

Refundable Credits, What Are They and How Are They Administered?

Refundable tax credits are a popular way to deliver social benefits, mainly because they are available to all eligible taxpayers, regardless of their tax liability. The refundability component allows the taxpayer claiming the credit to reduce his or her liability below zero dollars, creating a tax refund. The taxpayer claims the refundable credit in the section of the Form 1040 labeled “Payments.” As such, refundable credits are available to taxpayers even if they owe no income tax.⁸

⁵ However, there are exceptions to this general statement. The Health Coverage Tax Credit is an example of a tax expenditure for which eligibility is not initially determined by the taxpayer. Internal Revenue Code (IRC) § 7527. The Work Opportunity Tax Credit is another credit with eligibility determinations made by parties other than the taxpayer and the IRS. IRC § 51.

⁶ Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 U.C.L.A. L. Rev. 1867 (2004).

⁷ Jane G. Gravelle, Tax Policy Center, Urban Institute and Brookings Institution, *Tax Topic: Tax Expenditure*, available at <http://www.taxpolicycenter.org/taxtopics/encyclopedia/Tax-expenditures.cfm> (last visited Oct. 16, 2009).

⁸ In any given year, more than 35 percent of American households, which are home to almost half of the nation’s children, have no income tax liability. Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orsag, *Reforming Tax Incentives into Uniform Refundable Tax Credits*, Brookings Institution, Policy Brief Series No. 156 (Aug. 2006).

Running Social Programs Through the Tax System

Some Longstanding and Newly-Enacted Refundable Credits

The IRS administers various refundable credits. Longstanding credits include, but are not limited to:

- Earned Income Tax Credit;⁹
- Health Coverage Tax Credit;¹⁰ and
- Additional Child Tax Credit.¹¹

The passage of the American Recovery and Reinvestment Tax Act of 2009 in February 2009 created many tax incentives for individuals and businesses.¹² For individuals, ARRA established two new refundable credits for individuals: the Making Work Pay Credit and the American Opportunity Tax Credit.¹³ ARRA also enhanced the refundable First-Time Homebuyer Credit (FTHBC), and temporarily increased the refundable portions of the Additional Child Tax Credit and the EITC.¹⁴ ARRA also provides that eligible employees who are involuntarily terminated are entitled to receive an employer-provided subsidy in the amount of 65 percent of the premium for health insurance coverage under the Consolidated Omnibus Budget Reconciliation Act (COBRA)¹⁵ and are required to pay only 35 percent of such COBRA coverage. Employers must treat the 35 percent payment by

⁹ IRC § 32.

¹⁰ IRC § 35.

¹¹ IRC § 24.

¹² Pub. L. No. 111-5, Division B, 123 Stat. 306 (2009). Full a full description of the provisions under ARRA, see <http://www.irs.gov/newsroom/article/0,,id=204335,00.html?portlet=6> (last visited Oct. 11, 2009).

¹³ The Making Work Pay Credit is a refundable tax credit up to \$400 for working individuals and up to \$800 for working married taxpayers filing joint returns. This tax credit is calculated at a rate of 6.2 percent of earned income and phases out for taxpayers with modified adjusted gross income (MAGI) in excess of \$75,000, or \$150,000 for married couples filing jointly. For taxpayers who receive a paycheck and are subject to withholding, the credit is typically handled by their employers through mandated withholding changes, which result in an increase in take-home pay. Thus, wage earners receive an advance through reduced payroll withholdings. The amount of the credit to which the taxpayer is entitled is ultimately computed on the taxpayer's 2009 income tax return filed in 2010. Taxpayers who do not have taxes withheld by an employer during the year can claim the credit on their 2009 tax returns. The new American Opportunity Credit for qualified education expenses modifies the existing Hope Credit for tax years (TY) 2009 and 2010, making the Hope Credit available to a broader range of taxpayers, including many with higher incomes and those who owe no tax. It also expands the list of qualifying education expenses and allows the credit to be claimed for four post-secondary education years instead of two. Many of those eligible will qualify for the maximum annual credit of \$2,500 per student. The credit is fully available to individuals whose MAGI is \$80,000 or less, or \$160,000 or less for married couples filing a joint return, and phases out after those income thresholds. These income limits are higher than under the existing Hope and Lifetime Learning Credits.

¹⁴ Before ARRA, the FTHBC provided a refundable credit of up to \$7,500 for first-time homebuyers purchasing a main residence in 2008. Taxpayers were required to repay the credit in 15 equal, annual installments beginning with the 2010 income TY. ARRA expanded the FTHBC by increasing the credit amount to \$8,000 for purchases made by November 30, 2009. For homes purchased in 2009, taxpayers do not have to repay the credit unless the home ceases to be the taxpayer's main residence within a three-year period following the purchase. For purchases during the 2009 time period, taxpayers could claim the credit after the closing date on an original or amended 2008 return, or on a 2009 return before the closing date. For more information, see IRS, *First-Time Homebuyer Credit*, at <http://www.irs.gov/newsroom/article/0,,id=204671,00.html> (last visited Oct. 11, 2009). ARRA also increased for tax years 2009 and 2010 the amount of the EITC for taxpayers with three or more qualifying children to a maximum of \$5,657 as well as increased the phase-out thresholds for all taxpayers. Pub. L. No. 111-5, Division B, § 1006, 123 Stat. 306, 316 (2009). For more information, see IRS, *ARRA and the Earned Income Tax Credit*, at <http://www.irs.gov/newsroom/article/0,,id=205666,00.html> (last visited Oct. 11, 2009). Finally, ARRA made a portion of the ATCT refundable and lowered the minimum earned income limit to \$3,000 (from \$12,550). For more information, see <http://www.irs.gov/newsroom/article/0,,id=205670,00.html> (last visited Oct. 11, 2009).

¹⁵ Pub. L. No. 99-272, 100 Stat. 82 (1986).

eligible former employees as full payment, but are entitled to a refundable credit for the other 65 percent of the COBRA cost on their payroll tax returns.¹⁶

In November 2009, due to the success of ARRA's FTHBC provision in stimulating home purchases, Congress enacted the Worker, Homeownership, and Business Assistance Act of 2009.¹⁷ WHBA expanded the FTHBC by extending the deadline for qualifying home purchases and providing a smaller credit for "long-time residents" making qualifying home purchases.¹⁸

DISCUSSION

Does the Refundability Component Attract or Influence Noncompliance?

Noncompliance is best described as a continuum of behavior rather than in the absolute. Taxpayers and tax preparers commit noncompliance at varying degrees, including: inadvertent error, negligence, reckless disregard of the law, civil fraud, and criminal fraud.¹⁹ Many of these violations are "one-offs" or individual instances that are not routinely repeated. However, there is also a "cottage industry" of fraud perpetrators who search for opportunities to carry out schemes that involve minimal effort and risk.²⁰

In administering refundable credit programs, the IRS has developed initiatives designed to reduce the varying degrees of noncompliance.²¹ As discussed below, the refundability component of a tax-related social benefit program is not necessarily the main driver of noncompliance at any level, including fraud and abusive schemes. Nonrefundable tax credits and other expenditures are also subject to noncompliance, including fraudulent and abusive schemes, as long as the perpetrators have income tax to offset.

¹⁶ For more details on the COBRA provision in ARRA, IRS, *COBRA Health Insurance Continuation Premium Subsidy*, at <http://www.irs.gov/newsroom/article/0,,id=204505,00.html> (last visited Oct. 11, 2009).

¹⁷ Pub. L. No. 111-92, 123 Stat. 2984, § 11(Nov. 6, 2009).

¹⁸ Section 11 of WHBA extends the deadline for qualifying home purchases from Nov. 30, 2009, to April 30, 2010. Additionally, if a buyer enters into a binding contract by April 30, 2010, the buyer has until June 30, 2010, to settle on the purchase. The maximum credit amount remains at \$8,000 for a first-time homebuyer — that is, a buyer who has not owned a primary residence during the three years up to the date of purchase. However, the new law also provides a "long-time resident" credit of up to \$6,500 to others who do not qualify as "first-time homebuyers." To qualify this way, a buyer must have owned and used the same home as a principal or primary residence for at least five consecutive years of the eight-year period ending on the date of purchase of a new home as a primary residence. For all qualifying purchases in 2010, taxpayers have the option of claiming the credit on either their 2009 or 2010 tax returns. Pub. L. No. 111-92, 123 Stat. 2984, § 11(Nov. 6, 2009). For more information on WHBA, see IRS News Release, *First-Time Homebuyer Credit Extended to April 30, 2010; Some Current Homeowners Now Also Qualify*, IR-2009-108 (Nov. 24, 2009), available at <http://www.irs.gov/newsroom/article/0,,id=215791,00.html?portlet=7> (last visited Dec. 3, 2009).

¹⁹ For an analysis of compliance programs in response to varying degrees of noncompliance associated with the EITC, see Leslie Book, *The Poor and Tax Compliance: One Size. Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003). In addition, the Internal Revenue Code has various penalties to address these varying levels of noncompliance, including but not limited to: IRC § 6662 (accuracy-related penalty for negligence and reckless disregard of rules), IRC § 6663 (civil fraud penalty), and IRC § 7201 (criminal fraud).

²⁰ For a listing of some of the more significant abusive tax schemes prosecuted in 2009, see IRS, *Examples of Abusive Tax Scheme Investigations in 2009*, available at <http://www.irs.gov/compliance/enforcement/article/0,,id=187267,00.html> (last visited Dec. 21, 2009).

²¹ Leslie Book, *The Poor and Tax Compliance: One Size. Does Not Fit All*, 51 U. Kan. L. Rev. 1145 (2003). For a discussion of IRS initiatives to combat fraudulent schemes with the FTHBC, see *Administration of the First-Time Homebuyer Credit: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means* (Oct. 22, 2009) (statement of Linda E. Stiff, Deputy Comr. for Services and Enforcement, Internal Revenue Service).

The issue of fraud is much more nuanced than is generally portrayed. Fraud includes “one-offs” where individual taxpayers intentionally underreport income or inflate deductions or credits on an individual return basis. On the other side of the fraud continuum are the perpetrators of abusive schemes who are searching for “quick hits” – tax provisions with limited requirements, minimal third-party reporting data, and large dollar amounts of benefits. These schemers can bombard the system with claims for refunds based on these quick hits with the hope that a portion of the fraudulent claims will go undetected before the IRS pays out the refunds. As the IRS develops more sophisticated screens for identifying fraudulent schemes in one tax program, fraudsters move on to other areas. For example, whereas EITC schemes were prevalent early in this decade, it appears that withholding schemes are the most common today.²²

Thus, taxpayers in any income bracket can commit fraud with tax provisions other than refundable credits as long as they can offset tax. In fact, the data do not necessarily support the position that the refundability component actually attracts or influences noncompliance more than any other type of tax incentive. The amount of the benefit and the relative ease with which it can be obtained appear to be more significant factors. The following table illustrates that the refundability component of a tax benefit is not necessarily a main driver of substantial noncompliance. For example, fiscal year 2009 audits resulted in higher average audit adjustments for a few Schedule A itemized deductions than for some of the more common refundable credits.

TABLE 1: IRS FY 2009 Average Audit Adjustments by Tax Provision²³

Tax Benefit	Average Audit Adjustment
Charitable Contributions (Sched. A)	\$8,376
Medical Expenses (Sched. A)	\$6,749
Alternative Minimum Tax (AMT)	\$6,155
Child Tax Credit (CTC)	\$3,531
EITC	\$3,397
FTHBC	\$3,041

Furthermore, National Research Program (NRP) data for tax year 2001 suggest that approximately 55 percent (\$109 billion) of the individual underreporting gap (totaling approximately \$197 billion) came from understated net business income, such as unreported

²² During calendar year 2009 (through Dec. 2nd), the IRS’s Questionable Refund Program identified about 280,000 false and fraudulent returns claiming refunds of about \$1.9 billion. Of that total, the IRS disallowed about 192,000 returns, preventing the payment of about \$1.4 billion in improper claims. Most of the \$500 million balance of identified false and fraudulent claims was paid out as part of schemes before the IRS could act. The IRS reports that the vast majority of false and fraudulent refund claims involve income and withholding amounts ordinarily reported on Form W-2. IRS response to TAS information request (Dec. 16, 2009). As the IRS combats fraudulent noncompliance, financial institutions are also impacted by these abusive schemes, which often involve refund anticipation loans that give the schemer almost immediate access to the money.

²³ IRS Examination Operational Automation Database (EOAD), Compliance Data Warehouse (CDW) FY 2009. We acknowledge that the amounts of the refundable credits included in the chart are capped, which limits the amount of audit adjustments. However, the data still illustrate that tax provisions other than refundable credits are subject to high noncompliance.

receipts and overstated expenses for self-employed taxpayers. By contrast, only about nine percent (\$17 billion) came from overstated tax credits.²⁴

Based on these data, the National Taxpayer Advocate believes that noncompliance is not *necessarily* more prevalent in refundable credits than any other type of tax incentive. Refundability is needed to make the benefit accessible to the population of taxpayers without tax liabilities. It is not, in isolation, the main driver of noncompliance.

Instead, it is likely that the noncompliance often associated with refundable credits actually stems more from the overall design of the social benefit program rather than the refundability component. In a sense, refundability is akin to a Hitchcock “macguffin,” because it is perceived to play a leading role in the problems associated with the tax credit, but the component itself actually plays a minor role in noncompliance.²⁵

Design Elements that Impact Noncompliance Levels

The National Taxpayer Advocate believes that noncompliance associated with refundable credits stems from the overall design of the program. Specifically, the following elements contribute to the level of noncompliance in refundable credit programs: (1) fact-based eligibility requirements, (2) the lack of pre-certification procedures, (3) characteristics of the target population, (4) the large size of the benefit amounts, and (5) the role of return preparers in claiming the benefit.

Fact-Based Eligibility Criteria Make Verification Difficult for the IRS.

A main advantage of providing income-based social benefits through the tax code is that the IRS is the federal agency with the best access to income information of potential beneficiaries. However, the IRS’s data have limits. For example, many improper EITC claims arise because taxpayers fail to meet the requirement that a “qualifying child” must have lived with the taxpayer for more than one-half of the taxable year.²⁶ Although the IRS has done considerable work to develop screening criteria to distinguish valid from improper claims, the IRS has no way to systemically ascertain taxpayers’ living arrangements. The only way to verify eligibility of fact-based requirements is through taxpayer audits – unlike the caseworker model in traditional benefits programs, where the eligibility screening occurs before the taxpayer receives the benefit. The IRS could minimize the payment of improper claims if eligibility for tax benefits is based on criteria that the IRS can verify – ideally, before paying refunds.

²⁴ IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* 12, 14 (Aug. 2, 2007). In addition, approximately 28 percent (\$56 billion) of the individual underreporting gap came from underreported non-business income, such as wages, tips, interest, dividends, and capital gains. Approximately eight percent (\$15 billion) came from overstated subtractions from income (i.e., statutory adjustments, deductions, and exemptions).

²⁵ Merriam-Webster Dictionary defines “macguffin” as a term coined by Alfred Hitchcock to mean “an object, event, or character in a film or story that serves to set and keep the plot in motion despite usually lacking intrinsic importance.” “Macguffin,” Merriam-Webster Online Dictionary (2009), available at <http://www.merriam-webster.com/dictionary/macguffin> (last visited Dec. 21, 2009).

²⁶ See IRC § 32(c)(3)(A) (incorporating with modifications the definition of a “qualifying child” contained in IRC § 152(c)). IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns* 3, 13 (Feb. 28, 2002) (citing this requirement as one of the top three areas of EITC overclaims).

Running Social Programs Through the Tax System

Pre-certification Could Minimize Error and Fraud.

The IRS can combat noncompliance and reduce the number of frozen refunds associated with a refundable credit by performing eligibility certification before the filing season begins each January. Under such a program, the taxpayer demonstrates eligibility by producing documentation before filing a return. Pre-certification could be required for all taxpayers in the target population, or only for subsets of that population that have demonstrably high noncompliance rates. Pre-certification, however, moves the program closer to a traditional “welfare system” with direct benefit transfers and could have a negative impact on participation rates. Thus, before designing a pre-certification program for refundable tax credits, policymakers should weigh the burden imposed on taxpayers and IRS resources against the benefits of such a program. For example, the IRS gained experience performing eligibility pre-certifications during a pilot program for the EITC, which the IRS launched in 2003. The three-year test of pre-certification for the EITC incorporated a caseworker-like verification system. An IRS evaluation found certification a less efficient enforcement treatment than EITC correspondence examinations. Taxpayers subject to the certification requirement also made more phone calls to the IRS, which is not undesirable if those calls led to greater compliance. The results of the pilot indicated that the pre-certification requirement decreased participation in the EITC and increased the cost and burden on taxpayers.²⁷ In light of these findings, the IRS halted the pre-certification program.²⁸

Rather than discarding the idea entirely, the IRS could learn from its experience and design the precertification program to avoid the problems encountered with the pilot. For example, a redesigned program could require the taxpayer to demonstrate eligibility, but once the IRS processes this information, the taxpayer would remain eligible until either IRS systems flag a change in circumstances or the taxpayer voluntarily reports a change in circumstances that render him or her ineligible. Thus, the burden imposed on the taxpayer would be a one-time event and the taxpayer could avoid compliance issues relative to eligibility in the future. This approach may save IRS compliance resources downstream and be more attractive to taxpayers. Further, in order to prevent the decreased participation rate found in the pilot, the IRS could identify taxpayers who may be intimidated and perhaps add an incentive to encourage participation.

The Characteristics of the Target Population Can Lead to Compliance Challenges.

A primary reason to make a credit refundable is to reach individuals without tax liabilities. An estimated 47 percent of individual taxpayers have zero or negative liability, and may

²⁷ IRS, *IRS Earned Income Tax Credit (EITC) Initiatives, Addendum to the Report on Qualifying Child Residency, Certification, Filing Status, and Automated Underreporter Tests: Implementation of Alternative Approaches to Improving the Administration of EITC* (2008); IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress* (Oct. 2005). The lower participation rate may be attributable to taxpayers determining that they were not, in fact, eligible for the credit.

²⁸ IRS, *A Service-Wide Approach to Individual Refundable Tax Credits: Executive Summary – Background Paper 3* (Jun. 1, 2009).

have no filing obligations.²⁹ Thus, a significant portion of the target population may be unfamiliar with the tax preparation process yet is required to file returns solely to claim the credit. Moreover, the eligibility requirements for the credits may be so complicated that they drive well-intentioned taxpayers to make inadvertent errors. A large portion of the target population may be unable to handle the complex procedures required to claim the benefits without the assistance of a paid or volunteer tax return preparer.³⁰

Large Refund Amounts May Attract Fraudulent Schemes and Increase Demand for Commercial Refund Delivery Products.

Any tax incentive with a large dollar amount is ripe for abuse. Perpetrators of fraud quickly focus on tax provisions with large payouts. This is especially true for refundable credits, because the refundability component allows fraudsters to systematically claim refunds on behalf of fictitious taxpayers, or taxpayers whose identities were stolen, for tax dollars never actually paid into the system.

Further, an unintended consequence of delivering a sizeable social benefit through the tax system is that it could potentially drive more taxpayers to purchase costly commercial refund delivery products. Taxpayers are more willing to pay high fees associated with these products in order to access the sizable credit sooner. While some of these taxpayers may actually benefit from quicker access to the funds, many of them could wait a few more days to receive the money directly from the IRS at little or no cost. In addition, return preparers who market these products may have a financial incentive to artificially inflate refunds.³¹

The Role of Return Preparers and Strengthening Due Diligence Requirements.

The IRS considers tax return preparers its partners in tax administration due to their significant role in taxpayer compliance.³² In a sense, preparers are the government's first line of defense against noncompliance because they act as screeners on the government's behalf. Preparers can facilitate either compliance or noncompliance. Several studies and

²⁹ Robertson Williams, Tax Policy Center, Tax Facts, *Who Pays No Income Tax?* Tax Notes at 1583 (June 29, 2009), available at http://www.taxpolicycenter.org/UploadedPDF/1001289_who_pays.pdf (last visited Oct. 11, 2009). These taxpayers may still need to file a return to claim a refund of overwithheld income taxes.

³⁰ Janet Holtzblatt and Janet McCubbin, *Issues Affecting Low-Income Filers*, in *The Crisis in Tax Administration*, (Henry Aaron and Joel Slemrod, eds., Brookings Institution Press 2004). See also Michael S. Barr and Jane K. Dokko, *Tax Filing Experience and Withholding Preferences of Low- and Moderate-Income Households: Preliminary Evidence from a New Survey*, in *Recent Research on Tax Administration and Compliance: Selected Papers Given at the 2006 IRS Research Conference*, IRS Research Bulletin 193-212 (June 2006).

³¹ National Taxpayer Advocate 2007 Annual Report to Congress 83-95 (Most Serious Problem: *The Use and Disclosure of Tax Return Information by Preparers to Facilitate the Marketing of Refund Anticipation Loans and Other Products with High Abuse Potential*). See also Leslie Book, *Refund Anticipation Loans and the Tax Gap*, 20 Stan. L. & Policy Rev. 85 (2009).

³² IRS, *Strategic Plan, Fiscal Years 2009-2013*; National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, 74-116 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*); National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility, and Competence*).

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“shopping visit” initiatives by government watchdogs and regulators have identified preparers as a source of noncompliance for less sophisticated taxpayers.³³

In the 2003 Annual Report, the National Taxpayer Advocate recommended that Congress strengthen the EITC due diligence provisions.³⁴ We believe similar and robust provisions should apply to other tax provisions, where there is demonstrated noncompliance.³⁵ Further, as we have recommended since 2002, there should be a system of regulating, testing, and certifying unenrolled preparers.³⁶

Ideal Design Features for the Administration of a Social Benefit Program Through the Tax System

While it is feasible to administratively address some systemic problems that unexpectedly develop in social benefit tax programs, many require legislative resolution. The fundamental issue when designing a social benefit program is whether the benefit should run through the tax system or whether it is better suited for a direct spending program. This determination relies on a variety of factors, many of which are discussed in this section.

Evaluate Culture of the Potential Administrator

Before charging any federal agency with the administration of a social benefit, consideration should be given to whether the agency’s culture is best suited for this role. For example, if a social benefit has a family or welfare component, such as the EITC and Child Tax Credit, the administrator needs both a service and enforcement staff well trained in strong social service, communication, outreach, and education skills.

When Congress enacts a social benefit in the form of a tax incentive, the IRS is charged with administering a social benefit program, a role separate and apart from its role as an enforcement agency. Examinations are designed on the traditional IRS exam model, which is comprised of post-filing compliance and audits, in the context of an enforcement agency mission and mentality. Thus, the current design of the IRS is purely for revenue collection.

³³ See Most Serious Problem: *The IRS Lacks a Servicewide Return Preparer Strategy*, *supra*; Government Accountability Office, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* 2 (Apr. 4, 2006) (statement of Michael Brostek, Director - Strategic Issues, Before the Committee on Finance, U.S. Senate); Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2008-40-171, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* (Sept. 3, 2008); Statement of Jamie Woodward, Acting Commissioner, New York Dept. of Taxation and Finance, before IRS Tax Return Preparer Review Public Forum (Sept. 2, 2009), available at http://ftp.irs.gov/pub/irs-utl/ny_department_of_tax_statement.pdf (lasted visited Oct. 18, 2009); Tom Herman, *New York Sting Nabs Tax Preparers*, Wall Street Journal (Nov. 26, 2008); Russell Hubbard, *Tax Preparers Cheating Customers, Government, Alabama Nonprofit Finds*, Birmingham News (Jan. 23, 2009); National Community Law Center, *Tax Preparers Take a Bite out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuses in Durham and Philadelphia* (Apr. 2008); New York City Department of Consumer Affairs, Press Release, *NYC Department of Consumer Affairs Announces Citywide Enforcement Sweep of Income Tax Preparers* (Feb. 5, 2009).

³⁴ National Taxpayer Advocate 2003 Annual Report to Congress 270-301.

³⁵ For a comprehensive discussion of the role of return preparers in tax administration, including due diligence requirements, see *Most Serious Problem: The IRS Lacks a Servicewide Return Preparer Strategy*, *supra*; National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 44-74 (Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*); National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2., 74-116 (Leslie Book, *The Need to Increase Preparer Responsibility, Visibility and Competence*).

³⁶ National Taxpayer Advocate 2002 Annual Report to Congress 216-30.

When social program delivery is grafted to traditional IRS activities, there arises a potential conflict with the IRS's traditional mission. For example, when New Zealand's tax agency, Inland Revenue, was charged by the government with running social and family programs through the tax system through implementation of the Working for Families Tax Credits, the agency underwent a comprehensive analytical redesign process.³⁷ With the growth of these programs administered by the IRS, the agency should consider revising its mission statement to explicitly acknowledge its dual roles: tax compliance and social program delivery.³⁸

Evaluate the Feasibility of a Direct Spending Program.

Traditional direct spending welfare programs are perceived to be invasive and stigmatizing to the applicants and beneficiaries. One way to minimize public and participant aversion to such programs is to use the tax system to deliver the benefit, and thereby decrease awareness that the payment is inherently "welfare."³⁹ The EITC is an example of an income support program run through the tax system. While the credit is certainly beneficial for low income working taxpayers and families, it also forces a significant number of taxpayers with no filing obligations to file returns, and potentially incur high preparation, filing, and commercial refund delivery product fees, in order to claim the credit. An alternative approach would be to improve the direct spending welfare system by making the process less burdensome to participants.

Specific Identification of Targeted Population and Behavior.

Because specific taxpayer populations respond to incentives differently, any new social benefit program's targeted population and targeted behavior should be clearly identified during the legislative drafting process. By clearly identifying the targeted behaviors and populations, the future administrator of the benefit program will be better situated to increase the participation rate by effectively planning outreach and education initiatives. The administrator can also design compliance initiatives based on the specific needs of the target population. Finally, clearly identifying these groups and behaviors up front will lead to better measures of the program's effectiveness and help uncover unintended consequences.

³⁷ Robert Russell, Chief Executive and Commissioner of Inland Revenue, New Zealand, *Managing Expanding Responsibilities: Inland Revenue New Zealand*, Paper 16 (March 2008); Hon. Peter Dunne, Minister of Revenue, *Address to International Fiscal Association Conference 2009 New Zealand* Inland Revenue, (March 20, 2009), available at <http://www.taxpolicy.ird.govt.nz/news/archive.php?year=2009&view=651> (last visited Jun. 14, 2009) (Hon. Peter Dunn stated, "A very big challenge to the efficiency of our tax administration has arisen over the last decade or so from the strain placed on Inland Revenue tax systems by an ever increasing number of non-tax programmes that are administered through the tax system – programmes such as student loans, Working for Families tax credits and KiwiSaver. ... Over recent years, Inland Revenue systems designed for tax collection have been progressively adapted to cope with these and other social policy programmes.")

³⁸ See Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers are Not Being Adequately Met*, *supra*.

³⁹ Marjorie E. Kornhauser, *Cognitive Theory and the Delivery of Welfare Benefits*, 40 Loyola Univ. Chicago Law Journal 253-96 (2009).

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Tax Return Filing Obligations of Target Population.

Refundable tax credits are generally claimed at a higher rate than other forms of social welfare benefits.⁴⁰ A key reason is that most adult Americans file tax returns, so the added burden of claiming a credit is minimal compared with the need to file a separate application for other welfare benefits. Yet a significant number, estimated at 47 percent, of individual taxpayers have no filing obligations due to a zero or negative income tax liability.⁴¹ Although many of these taxpayers may still have to file a return in order to get a refund of overwithholding, it is a quantum leap from filing a basic return to filing a return to claim a credit with complex eligibility requirements. Thus, the burden imposed on the intended recipient is a key factor in the design of a benefit program.⁴² To minimize burden and maximize participation, a well-designed tax-based social program requires an understanding of the characteristics of the target population.⁴³

Eligibility Hinges upon Available Data.

The IRS touches a significant percentage of the U.S. population and has the income information and potentially other data necessary to gauge eligibility. The best-designed tax-based social programs are crafted in a way that eligibility to claim the credit is verifiable with data to which the IRS has access – ideally before the funds are even released.⁴⁴ Considerations include whether the credit requires information already captured on the income tax return or whether the IRS has direct or indirect access to other data sources that can serve as a proxy for eligibility. Alternatively, an eligibility determination might require information outside the current reach of the IRS absent an audit, making it difficult for the

⁴⁰ For example, the EITC participation rate is estimated at 75 percent (+/- two percent) for TY 2005. Dean Plueger, Wage & Investment Research, IRS and Amy O'Hara, Data Integration Division, U.S. Census Bureau, 2009 IRS Research Conference, *Earned Income Tax Credit TY2005 Taxpayer Participation Rate*, slide 15 (July 8, 2009). By comparison, TANF had an approximate 42 percent participation rate in 2004. Tax Policy Center, *Tax Facts: EITC, TANF, and Food Stamp Participation Rates, 1990-2004*, available at <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=273> (last visited Dec. 22, 2009). In addition, in 2008, approximately 3.8 million individuals received TANF as compared to 23.7 million receiving EITC. Department of Health & Human Services, Administration for Children and Families, 2008, *Temporary Assistance for Needy Families, Average Monthly Number of Recipients, Adults, and Children*, available at http://www.acf.hhs.gov/programs/ofa/data-reports/caseload/2008/2008_15months_tan.xls (last visited Oct. 15, 2009); IRS, *EITC Statistics, EITC State Statistics at-a-Glance for Tax Year 2008*, available at <http://www.eitc.irs.gov/central/eitcstats/> (last visited Oct. 15, 2009).

⁴¹ Robertson Williams, Tax Policy Center, Tax Facts, *Who Pays No Income Tax?* Tax Notes at 1583 (June 29, 2009), available at http://www.taxpolicycenter.org/UploadedPDF/1001289_who_pays.pdf (last visited on Oct. 11, 2009).

⁴² During the presidential election campaign, President Obama proposed that the IRS develop pre-populated returns to enable certain taxpayers to file without having to prepare a return or pay a preparer to do it. At present, a significant limitation is that the IRS does not receive Forms W-2 until the tax-filing season has ended. But as technology improvements enable the IRS to receive and process third-party information reports earlier, pre-populated returns may be one way to help reach eligible individuals who otherwise do not have a filing requirement. For information on a pre-populated return program implemented in California, see Joseph Bankman, *Simple Filing for Average Citizens: the California Ready Return*, 107 Tax Notes 1431 (2005); State of California Franchise Tax Board, *ReadyReturn General Information*, available at <http://www.ftb.ca.gov/readyreturn/about.shtml> (last visited Dec. 22, 2009) (In order to be eligible to file using California's ReadyReturn, taxpayers can not have claimed a credit other than the nonrefundable renter's credit on the previous year's tax return). See Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing*, *supra*.

⁴³ Outreach and education – i.e., demystifying the program – are important tools in maximizing participation. An example of an effective nationwide public awareness campaign conducted by the IRS is the annual EITC Awareness Day. IRS News Release, IR-2009-8, *IRS and Partners Mark EITC Awareness Day with Nationwide Events; EITC Could Mean Bigger Refunds for Millions of Taxpayers* (Jan. 30, 2009) (The news release provides general information about the credit, eligibility, and the availability of free filing assistance).

⁴⁴ Timely access to eligibility data may require earlier submissions to the IRS by third party reporting agents, a later start of the filing season, and faster data processing by the IRS. See Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing*, *supra*.

IRS to screen for noncompliance. An example of eligibility criteria hinging on inaccessible data is the residency test to determine if a taxpayer has a qualifying child for the EITC, which the IRS cannot verify without requiring the taxpayer to submit additional paperwork and face additional burden.⁴⁵ Further, any requirement to submit documentation to substantiate eligibility could potentially impact the rate of electronic filing if IRS computer systems are not timely programmed to accept such documentation.⁴⁶

Finally, when the IRS relies on documentation provided during audits to verify eligibility, it is placing an undue burden on the benefit recipients. For example, in connection with the Audit Barriers Survey project of 2007, TAS surveyed a random sample of taxpayers who claimed the EITC in TY 2004 to determine the type and frequency of barriers taxpayers face when dealing with EITC audits. The survey results found three main barriers: communication, documentation, and process. When asked about the documentation problems, over half of the audited taxpayers reported difficulties in obtaining requested documentation and nearly half did not understand why the IRS needed the information.⁴⁷

Incorporation of Third-Party Certifications Eases Verification Burden but Comes with Risks.

Instead of performing pre-certifications itself, the IRS could alternatively rely on other government or private entities to certify eligibility for refundable credits. Such reliance on other entities comes with both benefits and risks. The IRS does not have to expend resources on eligibility determinations because the outside party has already performed that task and may be better situated to do so. However, this reliance on outsiders places the IRS in a position of less control, and any breakdown in a system on the outside negatively impacts the IRS's administration of the credit. With some credits, such as the Health Coverage Tax Credit, the IRS merely acts as a paying agent and has no role in eligibility determinations, yet is still pulled into eligibility disputes as taxpayers try to contest eligibility decisions made by other entities.⁴⁸

The IRS encounters problems in administering the Work Opportunity Credit due to its reliance on third-party certifications performed by state workforce agencies. Administration of this credit relies on coordination between the IRS, the Department of Labor, and the state

⁴⁵ IRC §§ 32, 152(c).

⁴⁶ Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2009-400-13, *The 2009 Filing Season Was Successful, Despite Significant Challenges Presented by the Passage of New Tax Legislation* (Sept. 2009). To reduce erroneous FTHBC claims, TIGTA recommended that the IRS require taxpayers to provide third-party documentation supporting the purchase of a home. The IRS disagreed with the recommendation because it would burden taxpayers and prevent up to two million taxpayers from e-filing.

⁴⁷ National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 93-116 (*IRS Earned Income Credit Audits – A Challenge to Taxpayers*).

⁴⁸ IRC § 7527 provides the Health Coverage Tax Credit, a federal tax credit that pays 80 percent of qualified health insurance premiums for eligible individuals and their family members. An eligible individual receives a registration kit from an entity that determines eligibility and submits the completed registration forms to the IRS. The IRS bills the individual for 20 percent of the monthly health care premium. Once the IRS receives the payment, the IRS will send directly to the health insurance company 100 percent of the premium. Alternatively, the individual can pay the entire monthly premiums throughout the year, bypass the monthly subsidies, and claim the credit on his or her tax return. For more information on the Health Coverage Tax Credit Program, see <http://www.irs.gov/individuals/article/0,,id=187948,00.html> (last visited on Oct. 12, 2009).

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agencies. When state agencies fall behind in issuing certifications of eligibility to employers, employers cannot claim the credit.⁴⁹

Accelerating IRS Access to Reliable Third Party Information Reporting.

As structured today, third party reporting is inadequate for identifying eligibility before the IRS pays out the refunds. The IRS uses third-party information returns (*e.g.*, Form W-2, Forms 1099, and Schedules K-1) to verify the accuracy of income tax returns. However, the IRS does not process information returns until the filing season has ended and most refunds have been issued. Thus, the IRS does not have access to usable third-party data – reporting either income or other eligibility information – early enough to check the returns against the data as the returns are filed and before the IRS releases the refund (in a timely manner). Ideally, the IRS should receive and process information returns *before* it issues refunds. In designing social benefits through the tax system, Congress should require the Department of Treasury and the IRS to prepare a report identifying the administrative and legislative steps necessary to accomplish this goal.⁵⁰

Separate the Income and Fact-Based Components of Eligibility.

Tax administration would benefit if Congress designed refundable credits to target a very limited behavior. The IRS can effectively screen income-based eligibility criteria, but has difficulty screening the more facts-and-circumstances-based eligibility criteria, absent an audit. Thus, if Congress decides to deliver a benefit through the tax system, one approach is to isolate any income-based eligibility components to one credit and place the fact-based components in a separate credit. This design will result in more distinct credits with lower credit amounts. For example, rather than have a large credit like the EITC, the United Kingdom broke the credit into parts – the Working Tax Credit and the Child Tax Credit⁵¹ In the 2005 and 2008 Annual Reports, the National Taxpayer Advocate recommended that Congress consolidate all family status provisions into just two credits: The Family Credit and the Worker Credit.⁵² The earnings component of a credit can be easily verified through income reporting, leaving the more difficult family status eligibility verification to an isolated family credit. While the IRS would have more difficulty verifying the fact-based eligibility components, the amount at stake likely would be less than if the family-size

⁴⁹ Employers claim the Work Opportunity Credit for first year wages paid to an employee who is a member of a targeted group (the maximum credit allowed is \$2,400). The employer submits IRS Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit*, to the state workforce agency, which certified that the employee in question is a member of the targeted group. The employer needs the certification in order to claim the credit on IRS Form 55584, *Work Opportunity Credit*. The U.S. Department of Labor acts as a liaison with the state workforce agencies.

⁵⁰ For the National Taxpayer Advocate's legislative proposal to accelerate access to third-party reporting information, see Legislative Recommendation: *Direct the Treasury Department to Develop a Plan to Reverse the "Pay Refunds First, Verify Eligibility Later" Approach to Tax Return Processing*, *supra*.

⁵¹ For more information on the tax credits in the United Kingdom, see HM Revenue & Customs, *Tax Credits*, <http://www.hmrc.gov.uk/taxcredits/index.htm> (last visited on July 28, 2009).

⁵² National Taxpayer Advocate 2005 Annual Report to Congress 397-406; National Taxpayer Advocate 2008 Annual Report to Congress 363-69. The President's Advisory Panel on Federal Tax Reform under the Bush administration also proposed replacing the standard deduction, personal exemptions, CTC, and head of household filing status with a family credit, and replacing the EITC and the refundable Child Tax Credit with a working credit. President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005).

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component was included in the worker credit. As noted above, lower benefits may make the program less susceptible to individual cheating and fraudulent schemes.

Responsiveness of the Administrator to Deliver the Benefit in a Timely Manner.

When Congress distributes benefits to a targeted population to influence a particular behavior, an effective distribution system needs to accommodate the taxpayer's needs and ability to accomplish the desired behavior. Delivering a social benefit through the tax code creates significant timing and responsiveness issues. Because the taxpayer typically claims the incentive on a tax return during filing season, he or she may not receive the funds in time to alleviate economic stress. However, the IRS has means available to pay the benefit out earlier. For example, timing was a main reason behind the creation of the advanced EITC, which suffers a low participation rate.⁵³ Likewise, the Making Work Pay (MWP) Tax Credit of ARRA was designed to spread payments throughout the year by reducing the amount of taxes withheld on the withholding tables. However, delivery through the withholding tables caused many taxpayers who are ineligible for the MWP tax credit to under-withhold income taxes.⁵⁴

The United Kingdom tried to address the timing issue associated with its Child Tax Credit and Working Tax Credit by making weekly or monthly payments and requiring taxpayers to update their accounts promptly to reflect family and earning circumstances, with reconciliation at the year's end.⁵⁵ A thorough analysis of the AEITC, MWP, and UK experience will help identify those aspects of an advance payment option that increase responsiveness and participation.

⁵³ The advance EITC payment program allows taxpayers to receive part of the EITC through the employer. To participate in the program, the taxpayer must receive taxable wages, qualify for the EITC and have at least one qualifying child for the previous tax year. Taxpayers can determine eligibility and claim the advanced EITC (AEITC) by completing IRS Form W-5, *Earned Income Credit Advance Payment Certificate* and submitting to their employers. The maximum advanced EITC for TY 2009 is \$1,826. IRS Pub. 15, *(Circular E), Employer's Tax Guide For Use in 2009* 20 (rev. May 29, 2009); IRS Fact Sheet, *EITC Eligibility Rules Outlined*, FS-2009-09 (Jan. 2009).

⁵⁴ See *The Making Work Pay Tax Credit*, <http://www.irs.gov/newsroom/article/0,,id=204447,00.html> (last visited Oct. 16, 2009); Treasury Inspector General for Tax Administration, *Millions of Taxpayers May Be Negatively Affected by the Reduced Withholding Associated With the Making Work Pay Credit*, Ref. No. 2010-41-002 (Nov. 4, 2009).

⁵⁵ See <http://www.hmrc.gov.uk/taxcredits/keep-up-to-date/changes-affect/how-when-report.htm> (last visited on Oct. 16, 2009); <http://www.hmrc.gov.uk/taxcredits/payments-entitlement/payments/next-payment-due.htm> (last visited Jun. 14, 2009). As discussed below, timing is also an issue in the administration of the First Time Homebuyer Credit. Taxpayers do not have access to the benefit in time to make a down payment, because the taxpayer can only claim the credit on the return once the taxpayer has purchased the home. To address this timing issue, the Federal Housing Administration (FHA) developed a program to advance the amount of the tax credits to first-time homebuyers. See Department of Housing and Urban Development, News Release No. 09-072, *Donovan Announces Recovery Act's Homebuyer Tax Credit Can Immediately Help Thousands of First-Time Homebuyers to Buy a Home: FHA Plan will Stimulate New Home Sales and Help Stabilize Housing Market* (May 29, 2009); Department of Housing and Urban Development, *Mortgage Letter 2009-15* (May 29, 2009), available at <http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-15ml.doc> (last visited Oct. 16, 2009).

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Resources of the Administrator.

The IRS's core mission is to collect taxes, and it takes in about 96 percent of all federal receipts.⁵⁶ In recent years, considerable attention has been focused on the tax gap (the amount of tax due but not collected), and key members of Congress in charge of IRS oversight believe the IRS needs to do more to close the gap.⁵⁷ If the burden of administering new tax-based social benefit programs is excessive, it could impair the IRS's ability to deliver on its core tax-collection mission.⁵⁸ Implementing these provisions without adequate notice and resources will strain IRS systems and will likely lead the agency to divert resources from its core functions. In addition, like other federal agencies, the IRS faces a human capital crisis with more than 50 percent of its workforce eligible to retire in the near future.⁵⁹ Anticipated human capital problems are only exacerbated when the IRS is tasked with implementing entirely new programs.⁶⁰

Provide Enough Time to Implement New Provisions.

Changes in the tax law create challenges for the IRS, especially when the changes occur late in the year. The IRS must do extensive work to incorporate tax changes, including programming multiple computer systems; printing forms, instructions and publications; coordinating with tax software providers; and providing up-to-date training to employees who answer taxpayer questions as well as to Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) sites.

Late-year and one-time tax law changes cause even more challenges.⁶¹ For example, the IRS experienced difficulties administering the FTHBC in the early days of the 2009 filing season due to the late enactment of this provision. When ARRA expanded the FTHBC in February 2009, the IRS had to implement a compliance plan, and reprogram its computer systems with new compliance screening filters, at the height of the filing season. Due to the timing of the enactment, IRS systems were not programmed to timely process and

⁵⁶ See Department of the Treasury, Budget in Brief FY 2010, at 55.

⁵⁷ See, e.g., *Examining the Administration's Plan for Reducing the Tax Gap: What are the Goals, Benchmarks and Timetables?: Hearing Before the Senate Committee on Finance*, 110th Cong. (2007) (statement of Senator Max Baucus, Chairman of the Senate Committee on Finance), available at <http://finance.senate.gov/press/Bpress/2007press/prb041807b.pdf>. The IRS's most recent estimate of the voluntary compliance rate is 84 percent. Chairman Baucus urged the IRS to set a goal of achieving a 90 percent voluntary compliance rate by 2017.

⁵⁸ The IRS had to make certain tradeoffs to administer the Economic Stimulus Payment (ESP) program. See *The Status of Economic Stimulus Payments: Hearing Before the Subcomm. on Oversight and Social Security of the House Comm. on Ways and Means* (June 19, 2008) (statement of Nina E. Olson, National Taxpayer Advocate); *Tax Compliance Challenges Facing Financial Struggling Taxpayers: Hearing Before the Subcomm. on Oversight and Social Security of the House Comm. on Ways and Means* (Feb. 26, 2009) (statement of Nina E. Olson, National Taxpayer Advocate). For a detailed discussion of the implementation of the 2001 Advance Tax Rebate and Tax Rate Reduction Credit with little advance notice and the impact such implementation had on the IRS's other core functions, see W&I Research, IRS, *Lessons Learned from the IRS Implementation of the Advance Tax Refund and Tax Rate Reduction Credit Legislation*, Project Report 3-02-19-2-018 (Jan. 2003).

⁵⁹ TIGTA, Ref. No. 2009-10-118, *To Address Its Human Capital Challenge, the Internal Revenue Service Needs to Focus on Four Key Areas* (Aug. 19, 2009).

⁶⁰ See Press Release, United States Senate Committee on Finance, *Grassley Urges Accounting of Government Growth to Administer New Health Plan* (Oct. 1, 2009).

⁶¹ For additional information see National Taxpayer Advocate 2007 Annual Report to Congress 3-12 (Most Serious Problem: *The Impact of Late-Year Tax-Law Changes on Taxpayers*). A discussion of the IRS's comprehensive efforts in FY 2007 to deliver the Telephone Excise Tax Refund, a one-time credit claimed on over 94 million 2006 federal income tax returns, is included in IRS, *The Budget in Brief: Fiscal Year 2009*, at <http://www.irs.gov/pub/newsroom/budget-in-brief-2009.pdf>.

screen the new FTHBC claims. As a result, returns processed early in the filing season were not subject to the new filters and potentially inappropriate FTHBC claims were paid.⁶²

Social Benefit Programs Increase Tax Code Complexity and Impact the Fair Distribution of Benefits.

As more social benefit provisions are added to the tax code, they further complicate the task of simplifying the tax system. The existing refundable credits have few real common denominators. In part due to “legislative creep,” these provisions have different eligibility requirements, eligibility periods, income parameters, credit computations, phase-out thresholds and expiration dates. While many of these differences may be invisible to a significant number of taxpayers because they are addressed electronically in return preparation software, the increasing complexity raises the likelihood of mistakes. Complexity also makes it difficult for taxpayers to plan for taxes, and as a result, for lawmakers to incentivize behavior through the tax system.

The IRS has substantial experience administering previous tax provisions and may be able to head off problems by sharing lessons learned with legislators. The IRS, however, brings only one perspective to the table – that of the tax administrator. Thus, Congress also should consult with representatives of the target population, such as VITA program participants, Low Income Taxpayer Clinics (LITCs), and other nongovernmental organizations to learn the challenges faced by taxpayers in understanding eligibility for the program, computing and claiming the benefit on a return, receiving the benefit, and defending the claimant under audit or collection procedures.

New tax-based social benefit provisions may also interact with existing tax benefits in such a way as to undermine the incentives in the new provision. Because the various provisions have different phase-in and phase-out thresholds as well as eligibility requirements, the amount of the combined tax benefits actually reaching the targeted population may have an unintended and illogical result, including high marginal tax rates at eligibility phase-out or cliffs.⁶³

Complexity Imposes Transaction Costs on Taxpayers.

Due to the complexity of claiming a tax credit or other tax-based social benefit provision, the applicant may feel compelled to pay a tax preparer for assistance. In effect, as the provisions become increasingly complex, the government is imposing a fee on the target population, which is frequently low income. For example, the criteria for claiming the EITC lead approximately 60 percent of EITC claimants to seek help from preparers.⁶⁴ This

⁶² *Administration of the First-Time Homebuyer Credit: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means* 6 (Oct. 22, 2009) (statement of Linda E. Stiff, Deputy Comr. for Services and Enforcement, Internal Revenue Service); TIGTA, Ref. No. 2009-40-142, *The 2009 Filing Season was Successful Despite Significant Challenges Presented by the Passage of New Tax Legislation* (Sept. 21, 2009).

⁶³ Elaine Maag, Urban-Brookings Tax Policy Center, *Unified Credits for Low-Income Families*, Prepared for the American Tax Policy Institute (ATPI) Conference, “Tax Reform and the Low-Income Taxpayer” (Sept. 17, 2009).

⁶⁴ IRS Compliance Data Warehouse, Individual Returns Transaction File and EITC Tables (TY 2008).

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scenario raises issues of preparer oversight, cost of return preparation, consumer protection from potentially abusive products such as refund anticipation loans (RALs), and the policy question of why the beneficiary must pay to receive certain government benefits but not others.⁶⁵ In addition, pushing the cost of the application on to the taxpayer may mask the true cost of the program. For example, the EITC may not be as cost-effective as it initially appears if the additional costs borne by the applicant, such as return preparation, filing, and commercial refund product fees, are factored into the calculation.⁶⁶

Assessing the Impact of IRS Examinations on Beneficiaries of the Social Benefit Program.

Tax-based social benefit provisions should be designed to minimize noncompliance. No matter how well designed, however, there will be a need for some sort of compliance initiative. The target population of the benefit might have particular needs or experience difficulties navigating the IRS, especially the examination process. Low income taxpayers may experience language barriers, or financial or functional literacy limitations.⁶⁷ They may be unable to obtain traditional audit documentation (because they are more likely to be unbanked and don't have financial records) and may not even receive IRS correspondence (because they are more likely to be transient). The Audit Barriers Survey conducted by TAS in 2007 found that taxpayers subject to EITC correspondence examinations for TY 2004 faced significant barriers when negotiating EITC audits. Taxpayers had communication issues throughout the audits, experienced difficulties in providing requested documentation, and had further problems navigating the process. The survey also found that represented taxpayers kept more EITC than unrepresented taxpayers.⁶⁸

IRS Collection Actions Can Undermine the Intended Benefits of the Tax-based Social Benefit Provision.

Complex eligibility criteria and credit calculations, coupled with high dollar values, can transform an otherwise beneficial refundable credit into a trap for the unwary. For example, because the EITC is so complex and mistakes are common, taxpayers who claim the credit are at least twice as likely to be audited as other taxpayers.⁶⁹ Yet because the EITC is a low income tax benefit, many taxpayers whose EITC claims are initially paid and then denied on audit have already spent their refunds. IRS collection procedures require that a Notice of Federal Tax Lien (NTFL) be filed whenever a taxpayer with a debt of \$5,000 or more is placed in currently not collectible (CNC) status.⁷⁰ This notice damages the

⁶⁵ For a discussion of the concerns surrounding refund anticipation loans, see National Taxpayer Advocate 2007 Objectives Report to Congress, Vol. II (June 30, 2006).

⁶⁶ It is estimated that \$740 million in RAL fees were taken out of income tax refunds in 2003. Alan Berube and Tracy Kornblatt, *Step in the Right Direction: Recent Declines in Refund Loan Usage Among Low-Income Taxpayers*, Brookings Institution (Apr. 2005).

⁶⁷ See Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers are Not Being Adequately Met*, *supra*.

⁶⁸ National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 93-116 (*IRS Earned Income Credit Audits – A Challenge to Taxpayers*).

⁶⁹ See *IRS Data Book*, 2008, Table 9a (showing an average audit rate of slightly more than 2 percent for taxpayers claiming the EITC as opposed to about 1 percent for taxpayers overall).

⁷⁰ IRM 5.19.4.5.2(3) (Apr. 26, 2006).

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taxpayer's credit rating and negatively impacts a taxpayer's borrowing, employment, and housing opportunities.⁷¹ In addition, under IRC §6402, the IRS generally will offset the full amount of refunds owed on future tax returns even if the taxpayer's income remains low, and he or she is otherwise eligible for low income tax benefits.⁷²

To ensure that tax-based social benefit programs achieve their program goals, Congress should codify taxpayer rights protections associated with any new refundable credits. One such protection should limit the refund offset against the refundable portion of refunds attributable to means-tested credits.⁷³

Tax-Based Social Benefit Provisions Need Built-in Measures to Determine Effectiveness.

In addition to clearly defined policy goals, tax-based social benefit programs should incorporate a mechanism for evaluating their effectiveness. The collection of data pursuant to effectiveness measures will allow the administrator to determine if the program accomplishes its goals and to identify barriers to success. Periodic reports by the Department of the Treasury and the Joint Committee on Taxation are helpful in determining whether the program is achieving the intended result or whether and how it should be modified to achieve policy goals.

A Programmatic Approach Will Improve IRS Administration of Social Benefit Programs.

Because social benefit programs typically have an explicit policy goal, successful administration through the tax system requires the IRS to take a programmatic approach. The IRS currently maintains program offices for both the EITC and the Health Coverage Tax Credit within the Wage and Investment (W&I) Operating Division. However, this program office structure has some limitations. For example, the EITC program office controls the use of appropriated funds, but does not have jurisdiction over procedures used by audit and collection resources with respect to the target population. This bifurcated approach results in the compliance functions not conforming their traditional enforcement procedures to the needs and characteristics of the target population. As noted above, failure to account for the target population's challenges can result in inaccurate audit results and unnecessary harm to the taxpayer.

Although not all tax-based social benefit programs will require a separate program office, those targeting taxpayer populations with special needs – such as EITC – will benefit from the programmatic approach. And unlike the current EITC program office, a comprehensive

⁷¹ See Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of the Law, Fail to Promote Future Tax Compliance, and Unnecessarily Harm Taxpayers*, Vol. 1, *supra*.

⁷² In the United Kingdom, HM Revenue and Customs cannot offset a tax credit more than 25 percent to satisfy a previous year tax debt, with exception. See HM Revenue and Customs, *Tax Bulletin Issue 74*, available at <http://www.hmrc.gov.uk/bulletins/tbissue74.htm> (last visited Oct. 12, 2009).

⁷³ For a legislative proposal on limiting refund offsets on refundable credit proceeds, see Legislative Recommendation: *Impose Collection Protections on Refund Offsets for EITC Recipients*, Vol. 1, *supra*.

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programmatic approach will necessitate the program office having jurisdiction over examination and collection guidance, if not the actual compliance personnel.

Administrability Issues Specific to the EITC.

The IRS faces challenges in administering social benefit programs designed as refundable credits. The following discussion sets forth issues specific to the administration of the EITC.

Taxpayers Face Difficulty in Navigating Complicated EITC Eligibility Requirements.

The EITC's complex eligibility requirements include income, housing, and family status elements. This complexity can lead even well-intentioned taxpayers to make errors and the IRS to pay inappropriate claims.⁷⁴ In fact, the complexity of claiming this credit drives over 70 percent of EITC taxpayers to rely on tax return preparers.⁷⁵ An IRS compliance study for TY 1999 attributed approximately 70 percent of EITC overclaims to tax returns completed by paid preparers.⁷⁶

IRS Faces Difficulty in Verifying Facts-and-Circumstances-Based EITC Eligibility Requirements.

The EITC is a sizable credit, with approximately 23.7 million recipients receiving approximately \$49 billion for tax year 2008. However, the EITC's complex facts-and-circumstances-based eligibility requirements present the IRS with difficulties in verifying eligibility without auditing the taxpayers.⁷⁷ Eligibility to claim the EITC is based on the taxpayer's filing status, the taxpayer's earned income, and how many qualifying children the taxpayer can claim. For a taxpayer to claim an individual as a qualifying child, the individual must meet the following four tests (1) relationship test, (2) residency test, (3) age test, and (4) support test.⁷⁸ The IRS has the capability to verify the income and age elements of eligibility once it has received and processed third-party reporting data. However, the IRS has difficulties verifying the more personal facts-and-circumstances-based elements of relationship, residency, and support other than during the examination process.⁷⁹

As discussed above, a less burdensome approach to administration of the EITC is to separate out the personal or fact-based component from the income component, resulting

⁷⁴ For example, a TY 2001 reporting compliance study estimated the level of improper overclaims for fiscal year 2007 to range from \$10.4 - \$12.3 billion and 23 percent (lower bound) to 28 percent (upper bound) of approximately \$44.5 billion in total program payments. Department of Treasury, *Fiscal Year 2007 Performance and Accountability Report*, Part IV, Appendix C: Improper Payments Information Act 280 (Nov. 15, 2007).

⁷⁵ IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006).

⁷⁶ GAO, GAO-08-800R, *Refund Anticipation Loans* (June 2008).

⁷⁷ IRS, EITC Database, Compliance Data Warehouse, Data Extracted on September, 16, 2009, available at <http://www.eitc.irs.gov/central/eitcstats/> (last visited Dec. 22, 2009).

⁷⁸ IRC § 32. For more details eligibility to claim the EITC based on the qualifying child determination, see Most Litigated Issue: *Family Status Issues Under Internal Revenue Code Sections 2, 24, 32, and 151*, *supra*.

⁷⁹ The IRS has access to Social Security data which can link a child's Social Security number (SSN) to the mother and father, if identified.

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in two smaller credits with different eligibility criteria. The IRS could screen the income-based credit and pay benefits as soon as it obtains access to the income reporting data. The IRS may still have difficulties screening claims for the smaller relationship-based credit, but the amount at stake would be less than the current EITC, providing less incentive to cheat.

When the IRS is charged with administering a credit with personal factual eligibility criteria, as discussed above, the IRS should consider instituting a pre-certification requirement or option. Once the taxpayer produces the required documentation, the IRS computers would indicate eligibility and the taxpayer no longer would face this burden until he or she voluntarily reports a change in circumstances or the IRS systems flag such a change.

Taxpayers Face Difficulties Navigating the IRS EITC Correspondence Exam Process.

EITC taxpayers under audit have demonstrated difficulty navigating the IRS correspondence examination process. For example, in a study performed by the Taxpayer Advocate Service in 2004, approximately 43 percent of taxpayers seeking reconsideration of audits that disallowed EITC in whole or in part received additional EITC through the reconsideration. Moreover, these taxpayers received, on average, 94 percent of the EITC they claimed on the original returns. Thus, for 43 percent of taxpayers seeking audit reconsideration, their original audit results did not reflect their eligibility for the EITC – they merely flunked the IRS audit process. In addition, in more than 40 percent of the cases reviewed, difficulties with IRS documentation requirements were identified as the reason for EITC audit reconsideration.⁸⁰

As a follow-up to the audit reconsideration study, TAS conducted an Audit Barriers Survey project in 2007 that found this particular taxpayer population faces significant barriers when negotiating the EITC audit process. Taxpayers subject to EITC correspondence exams for TY 2004 returns had communication difficulties throughout the audits, experienced difficulties in providing requested documentation, and had difficulties navigating the correspondence exam process. In fact, 26.5 percent of the survey respondents did not even know they were subject to an IRS audit and 23 percent indicated they would have preferred to communicate with the IRS in person.⁸¹

Both the EITC Audit Reconsideration study and EITC Audit Barriers Survey highlight the problems taxpayers experience in meeting the IRS requirements for providing documentation to prove their EITC claims. This difficulty can cause taxpayers to become discouraged and possibly ignore the IRS request entirely. As part of the 2004 EITC certification study, the IRS piloted the use of affidavits (from third parties such as social workers and clergy) to allow taxpayers to prove they met the qualifying child residency requirement. The study results indicate the affidavit is the most effective and accurate means of proving eligibility

⁸⁰ National Taxpayer Advocate 2004 Annual Report to Congress vol. 2 (*Earned Income Tax Credit (EITC) Audit Reconsideration Study*).

⁸¹ National Taxpayer Advocate 2007 Annual Report to Congress vol. 2, 93-116 (*IRS Earned Income Credit Audits – A Challenge to Taxpayers*).

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and taxpayers prefer the affidavit to providing documents, records, or letters.⁸² The IRS has indicated that it is poised to conduct another test with a larger sample to test the use of a third-party affidavit as alternative documentation to prove the residency requirement during an EITC exam.⁸³ Given the difficulties taxpayers face in obtaining needed documentation, the effectiveness of the affidavit, and taxpayers' willingness to use the new form, we commend the IRS for this initiative and encourage the IRS to expand the use of the affidavit to all EITC examinations. This approach may also encourage increased participation by taxpayers if they know they are capable of sending the IRS the requested information. Based on the EITC certification study, the IRS should also test other methods of proof to determine which are most accurate and best suited for IRS and taxpayer needs. The IRS can continue to gather data regarding the use of affidavits while expanding their use to all EITC examinations in the near future.⁸⁴

In addition, to address the audit barriers faced by EITC taxpayers, the IRS should conduct research to determine the causes of noncompliance in the target population and tailor its different compliance techniques to address each specific cause.⁸⁵ The IRS also should increase awareness of legal assistance available through the LITC program, which can have a significant positive impact on the outcomes of EITC audits.⁸⁶

Finally, although the IRS has a significant amount of research about the EITC population, this information is concentrated on the taxpayers' pre-filing and filing assistance needs. The IRS lacks sufficient research on EITC taxpayers' needs and preferences during examination and collection processes.⁸⁷ This lack of post-filing research results in a revenue-raising mentality rather than incorporating the agency's social knowledge into its compliance strategy.

⁸² IRS, *IRS Earned Income Tax Credit (EITC) Initiative: Final Report to Congress* (Oct. 2005). The IRS conducted the second certification study from December 2004 through April 2005 for TY 2004. The study looked at a random sample of 25,000 EITC claimants for whom the IRS could not establish qualifying child eligibility through available data. The 2004 certification study marked the first time IRS examination routinely used affidavits for tax administration purposes.

⁸³ See Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers are Not Being Adequately Met*, *supra*.

⁸⁴ See National Taxpayer Advocate 2007 Annual Report to Congress 244 (Most Serious Problem: *EITC Examinations and the Impact of Taxpayer Representation*).

⁸⁵ See Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003); Nina E. Olson, *Symposium: Closing the Tax Gap: A Ten-Step Program for Better Tax Compliance*, 20 Stan. L. & Policy Rev. 7 (2009).

⁸⁶ See National Taxpayer Advocate 2007 Annual Report to Congress vol. 2 at 94-116 (*IRS Earned Income Credit Audits — A Challenge to Taxpayers*).

⁸⁷ See Most Serious Problem: *Beyond EITC: The Needs of Low Income Taxpayers are Not Being Adequately Met*, *supra*.

Timing of EITC Payments Limits Responsiveness and Increases Taxpayer Compliance Costs.

EITC recipients use their EITC-related refunds to pay for necessities⁸⁸ and need the money as quickly as possible. Unless they elected to receive the Advance EITC, which suffers from a low participation rate,⁸⁹ taxpayers must wait to receive their benefits until they claim the refund on the next tax return. In addition, many taxpayers incur substantial fees associated with commercial refund delivery products in order to get their money quickly.⁹⁰ By contrast, the United Kingdom has a “pay as you go” system where the taxpayer receives the credit proceeds incrementally throughout the year. Under this system, the taxpayer is required to inform the administrator of any relevant change in circumstances and HMRC adjusts payment awards accordingly.⁹¹

Administrability Problems Specific to the Delivery of Economic Stimulus Payments

The administration of the ESP program illustrates that the IRS can compromise its ability to perform its core mission when it is asked to take on non-core tasks. Congress passed the Economic Stimulus Act in February 2008; at the time, the IRS seemed like a logical agency to administer the delivery of the payments. However, this was a massive undertaking and came when the IRS was already in the midst of a challenging 2008 filing season.

While, on balance, the IRS did an outstanding job administering both the 2008 filing season and the ESP program, it certainly had to make significant trade-offs. For example, the IRS was not able to staff its telephone lines adequately and the level of service (LOS) on toll-free lines dropped sharply, from 83 percent during the 2007 filing season to 77 percent during the 2008 filing season.⁹² In addition, because the IRS shifted customer service representatives from assisting with correspondence to answering phones, the productivity in processing paper correspondence declined and inventory rose sharply. The LOS for the IRS’s automated collection system telephone lines also declined due to a shift in personnel. These declines in service had serious consequences on taxpayers and increased their compliance burden. The program also created a burden on tax administration and impacted the public fisc as the reassignment of collection employees resulted in reduced collections.⁹³

⁸⁸ Robert Greenstein, Executive Director of the Center on Budget and Policy Priorities, *The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor* (Aug. 17, 2005), available at <http://www.cbpp.org/cms/index.cfm?fa=archivePage&id=7-19-05eic.htm> (last visited Dec. 8, 2009).

⁸⁹ GAO, GAO-07-1110, *Advance Earned Income Tax Credit: Low Use and Small Dollars Paid Impede IRS’s Efforts to Reduce High Noncompliance* (Aug. 2007).

⁹⁰ GAO, GAO-08-800R, *Refund Anticipation Loans* (June 2008).

⁹¹ For more information on the application and payments of tax credits in the United Kingdom, see <http://www.hmrc.gov.uk/taxcredits/start/who-qualifies/overview/what-are-taxcredits.htm> (last visited on Dec. 13, 2009).

⁹² IRS, JOC Enterprise Telephone Data. Enterprise Snapshot. In fact, the IRS continued to experiencing a decline, with a 64 percent LOS during the 2009 filing season. TIGTA, Ref. No. 2009-40-127, *Unplanned Call Demand Reduced Toll-Free Telephone Access for the 2009 Filing Season 5* (Sept. 8, 2009). See Most Serious Problem: *IRS Toll-Free Telephone Service is Declining as Taxpayer Demand for Telephone Service is Increasing*, *supra*.

⁹³ For details of the impact the ESP program had on IRS services and enforcement activity, see *The Status of Economic Stimulus Payments: Hearing Before Subcomm. on Oversight and Social Security of the House Comm. on Ways and Means* (June 19, 2008) (statement of Nina E. Olson, National Taxpayer Advocate).

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The most significant challenges arose with respect to the approximately 20.5 million taxpayers who were eligible for a payment but had no current IRS filing requirement, *i.e.*, very low income taxpayers, including low income beneficiaries of Social Security and Veterans' benefits.⁹⁴ In hindsight, considering the burden imposed on both taxpayers and tax administration, it is reasonable to question whether the IRS was the appropriate forum to administer the ESP program to these individuals. The Social Security Administration (SSA) and the Department of Veteran's Affairs (VA) may have been better positioned to deliver the payments to their beneficiaries because the agencies have access to recipients' names, addresses, and bank account information. In fact, in ARRA, Congress chose the SSA, Department of Veterans Affairs, and the Railroad Retirement Board to administer the Economic Recovery Payment, a one-time \$250 payment to individuals who receive Social Security, Supplemental Security Income (SSI), Railroad Retirement and Veterans' Compensation and Pension benefits.⁹⁵

Administrability Problems Specific to the First Time Homebuyer Credit

As part of an effort to stimulate the United States housing market, Congress expanded the FTHBC in the American Recovery and Reinvestment Act of 2009 in February 2009, as the IRS was in the midst of the 2009 filing season. In fact, the IRS was tasked with administering two distinct FTHBC provisions during the filing season: the initial credit created under the Housing and Economic Recovery Act of 2008 (HERA) and the new expanded credit under ARRA.⁹⁶

The expanded provision clearly affected home purchases. Through September 2009, the IRS processed FTHBC claims on more than 1.5 million returns.⁹⁷ Moreover, the Joint Committee on Taxation estimates that a majority of FTHBC claims will occur in 2010 when taxpayers file their 2009 returns.⁹⁸ Despite the successful impact on home purchases, the IRS faced significant challenges in administering the program and will continue to do so as it administers the newly expanded credit in the Worker, Homeownership and Business Assistance Act of 2009 (WHBA).⁹⁹ Under the new law, an eligible taxpayer must buy, or enter into a binding contract to buy, a principal residence on or before April 30, 2010 and close on the home by June 30, 2010. For qualifying purchases in 2010, taxpayers have

⁹⁴ See *Implementing the Economic Stimulus Payment Program: Hearing Before Subcomm. on Oversight and Social Security of the House Comm. on Ways and Means 4-5* (June 19, 2008)(statement of Douglas H. Shulman, Commissioner, IRS).

⁹⁵ Pub. L. No. 111-5, § 2201, 123 Stat. 115, 450 (Feb. 2009).

⁹⁶ HERA, Pub. L. 110-289, 122 STAT. 2851 (July 30, 2008), created a FTHBC limited to \$7,500 for purchases of principal residences after April 8, 2008 and before July 1, 2009. The credit phased out when taxpayers had MAGI of more than \$75,000 for individuals (\$150,000 for joint filers) and the credit served as an interest-free loan to be paid back over a 15-year period. ARRA expanded the provision by raising the maximum amount to \$8,000, extended the time period for purchases to after January 1, 2009 and before December 1, 2009. Claimants were no longer required to pay back the proceeds under ARRA and could claim the credit on an amended TY 2008 return or 2009 return. ARRA, Pub. L. No 111-5, 123 Stat. 115 (Feb. 2009).

⁹⁷ *Administration of the First-Time Homebuyer Credit: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means* (Oct. 22, 2009) (statement of Linda E. Stiff, Deputy Comr. for Services and Enforcement, Internal Revenue Service).

⁹⁸ United States Government Accountability Office, *First-Time Homebuyer Tax Credit: Taxpayers' Use of the Credit and Implementation and Compliance Challenges, Testimony Before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives*, GAO-10-166T (Oct. 22, 2009)

⁹⁹ Pub. L. No. 111-92, 123 Stat. 2984, § 11(Nov. 6, 2009).

the option of claiming the credit on either their 2009 or 2010 return. The new law also raises the income limitations and authorizes the credit for long-time homeowners buying a replacement principal residence.

The Timing of FTHBC Payments Creates Monetization Challenges.

Congress intended to stimulate the real estate market when it first enacted and subsequently enhanced the FTHBC. The credit was designed to assist taxpayers in making down payments on their first homes. However, timing of the payments quickly became an issue. To receive the credit proceeds, taxpayers could either file an amended return or wait to claim the credit in the next filing season. Thus, taxpayers would have to wait a potentially significant amount of time between closing on the home and receiving the funds. The delay in monetizing the credit threatened to undermine its intended incentive effect. To address this issue, the Federal Housing Administration developed a program to advance the credit to first-time homebuyers.¹⁰⁰

The Timing of Credit Claims Created Audit Selection Challenges.

Once Congress enacted the FTHBC as part of ARRA, the IRS took steps to implement a compliance plan through screening filters that would identify inappropriate claims. The screens identified and selected for audit the highest-risk FTHBC claims before issuing refunds. However, the screens were implemented incrementally because the expansion occurred at the height of the 2009 filing season. Thus, the IRS released some refunds associated with problematic returns, which will be subject to post-refund examinations. As of October 19, 2009, the IRS had selected more than 100,000 FTHBC returns for audit as a result of the screens.¹⁰¹

IRS Has Limited Means for Pre-Refund Verification of Eligibility.

Eligibility to claim the credit relies on several factors, including income, date of home purchase, and whether the taxpayer owned a primary residence during the previous three years. To claim the credit, taxpayers must complete Form 5405, *First-Time Homebuyer Credit*, which requires the taxpayer to provide eligibility information and must be filed with the Form 1040. The IRS considered requiring taxpayers to attach additional documentation to substantiate eligibility, such as the HUD-1 Settlement Statement, but decided against this approach due to electronic filing concerns.¹⁰² Thus, the IRS currently has no way to match documentation up front before paying out the sizable refundable credit.

¹⁰⁰ See Department of Housing and Urban Development (HUD), News Release No. 09-072, *Donovan Announces Recovery Act's Homebuyer Tax Credit Can Immediately Help Thousands of First-Time Homebuyers to Buy a Home: FHA Plan will Stimulate New Home Sales and Help Stabilize Housing Market* (May 29, 2009); U.S. Dept. of Housing and Urban Development, *Mortgage Letter 2009-15* (May 29, 2009), available at <http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-15ml.doc> (last visited Jun. 25, 2009).

¹⁰¹ *Administration of the First-Time Homebuyer Credit: Hearing Before the Subcomm. on Oversight of the H.Comm. on Ways and Means* (Oct. 22, 2009) (statement of Linda E. Stiff, Deputy Comr. for Services and Enforcement, Internal Revenue Service).

¹⁰² *Id.*

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It relies on compliance screens to catch inadvertent noncompliance as well as claims submitted pursuant to fraudulent schemes.

The FTHBC program could be reconfigured to minimize revenue loss by requiring third-party reporting to the IRS before it pays out these proceeds. The IRS could receive this information through electronically-filed third-party reporting received directly from the financial institutions or through HUD.¹⁰³ Alternatively, the IRS could require taxpayers to scan in their HUD-1 Settlement Statements and submit electronically with their returns. Either alternative may require the IRS to delay the FTHBC portion of refunds until it processes the third-party reporting information. However, requiring such eligibility documentation before paying out the proceeds could reduce fraud.¹⁰⁴

Future Design of the FTHBC Program.

If the IRS cannot receive and timely process eligibility documentation on the front end, it will continue to freeze a significant percentage of refunds containing these refundable credits. These delays will hurt the target population of these provisions, who factor the credit proceeds into their home-buying decisions. Taxpayers likely anticipate typical refund turnaround times and rely on the proceeds to pay expenses associated with the new home purchase. While it may be too late to resolve the issues associated with the existing expanded FTHBC, any similar future programs may be better structured as direct spending programs with payments administered directly by the agency with the most connection to the targeted behavior.

Thus, it is our belief that the FHA or a related agency would best administer the program. The closing agent would be required to conduct due diligence on behalf of the FHA at the sale and provide the necessary funds when needed by the purchaser – *i.e.*, at the time of purchase. The closing agent or lender also would have direct access to eligibility information due to its connection with the transaction.¹⁰⁵

This design would benefit both the recipients and the federal government. As the program is currently designed, taxpayers do not receive the benefit in time to make a down payment, because they can only claim the credit on either an amended or original return once they have purchased the homes. In fact, in response to this perceived weakness in

¹⁰³ For example, the IRS could add a box on the Form 1098 or create a new form to provide information necessary for the IRS to effectively administer the credit. The box could provide the closing date and the purchase price of the home. The IRS would need to receive the Form 1098 before releasing the refund. Perhaps the closing agent could file a modified Form 1098 with the IRS within a reasonable time period after the closing. Thus, the filing deadline of the revised Form 1098, for purposes of the FTHBC, would be tied to the closing date rather than the filing season.

¹⁰⁴ At least one taxpayer who claimed the FTHBC submitted to the IRS a fake closing statement prepared by a commercial online company initially called falseexpense.com, a website which, at the time of drafting, redirects users to a website called salesreceiptstore.com (last visited Dec. 22, 2009).

¹⁰⁵ Income eligibility for the credit is based on the current year income. Thus, the closing agent would not have access to the data needed to determine eligibility with absolute certainty. However, through use of the existing Income Verification Express Service (IVES), the lender could verify the previous year income, which would provide an acceptable degree of certainty. The IVES program is used by mortgage lenders and others within the financial community to confirm the income of a borrower during the processing of a loan application. With the consent of the taxpayer, the IRS provides the return transcript, W-2 transcript and 1099 transcript information generally within two business days to a third party. IRS, *Income Verification Service*, at <http://www.irs.gov/individuals/article/0,,id=161649,00.html> (last visited Dec. 28, 2009).

the design of the program, the FHA developed a program to advance the amount of the tax credits to first-time homebuyers.¹⁰⁶ Congress can prevent the need for such retroactive efforts by addressing monetization issues in the design of the provision. Were the program designed as a direct spending program, directly administered by the FHA, there would be no monetization issue and improved compliance protections.¹⁰⁷

Alternatively, the FTHBC program could be a hybrid of a tax credit and direct spending program. The FHA could advance the money to the purchaser in a manner similar to the FHA loan program currently in place. However, rather than have the taxpayer receive the funds in a tax refund and subsequently pay FHA, the IRS could transmit the money directly to FHA upon verification of the return. If the taxpayer fails to correctly claim the credit on the return, he or she would be liable to reimburse the FHA for any outstanding balances, because the FHA loan program attaches a second lien on the residence. This approach is less attractive than the above-discussed direct spending approach, because it really amounts to the IRS repaying another federal agency, but it does eliminate monetization concerns.

CONCLUSION

The design of a social benefit program is key to its effectiveness. There are many advantages to running a program through the tax system, primarily due to the IRS's vast reach, store of financial data, and recent experience in administering similar programs. Refundable tax credits are often favored as the vehicle to deliver social benefits, yet they are also associated with noncompliance. The National Taxpayer Advocate believes that noncompliance is not necessarily more prevalent in refundable credits than any other type of tax incentive. Such noncompliance may actually stem from the design of the social benefit program rather than the refundability component of the tax credit. For example, eligibility determinations and benefit amount calculations may be too complex for the particular target population. The large monetary amount of the incentive also may attract abuse tax schemes. Further, it is difficult to prevent noncompliance if the administrator cannot access documentation needed to verify eligibility before paying out the benefit payment.

The optimal design of a social benefit program maximizes participation and compliance levels. To achieve the optimal design, it is necessary to learn from the experience of the IRS in running such programs as the EITC, FTHBC, and ESP programs. While the IRS does have broad experience in administering these programs, it has also faced significant

¹⁰⁶ See Department of Housing and Urban Development, News Release No. 09-072, *Donovan Announces Recovery Act's Homebuyer Tax Credit Can Immediately Help Thousands of First-Time Homebuyers to Buy a Home: FHA Plan will Stimulate New Home Sales and Help Stabilize Housing Market* (May 29, 2009); U.S. Dept. of Housing and Urban Development, *Mortgage Letter 2009-15* (May 29, 2009), available at <http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-15ml.doc> (last Oct. 16, 2009).

¹⁰⁷ Congress took a similar direct spending approach in the recent "Cash for Clunkers" program. While Congress could have created a tax incentive to encourage taxpayers to purchase new fuel-efficient automobiles, it instead designed the Car Allowance Rebate System (CARS). CARS is administered by the National Highway Traffic Safety Administration (NHTSA), but the car consumers received their payments directly from their car dealers, which were subsequently reimbursed by the NHTSA through electronic funds transfer. For more information on the CARS program, see www.cars.gov (last visited Oct. 12, 2009); Consumer Assistance to Recycle and Save Program, 13 U.S.C. 1301 et seq.

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challenges, many of which could have been avoided if the program had been designed differently, and in some instances created as direct spending programs not administered by the IRS. Moreover, in addressing noncompliance, the traditional IRS approach to audits and collection can undermine the very policy goals the program was designed to achieve. Accordingly, the National Taxpayer Advocate believes it is crucial to understand the needs of the target population as well as the strengths and limitations of the proposed program administrator in order to structure an effective program.

**TAXPAYER ADVOCATE
SERVICE SURVEY OF FEDERAL
GOVERNMENT EXTERNAL
OMBUDSMEN**

Annual Report to Congress

2009

Annual Report to Congress

Taxpayer Advocate Service Survey of Federal Government External Ombudsmen¹

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¹ The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. The principal author of this report is Megan B. Kenney, Attorney Advisor to the National Taxpayer Advocate.

INTRODUCTION

In 2003, the Taxpayer Advocate Service (TAS) published a report titled: *Independent Advocacy Agencies Within Agencies: A Survey of Federal Agency External Ombudsmen*. The report examined the structure of the office of the National Taxpayer Advocate, as well as other federal ombudsmen offices, based on survey responses collected by TAS and publicly available information. The initial report surveyed the breadth of the structure of federal external ombudsmen offices in existence at the time and provided an overview of the function of those offices.

For the 2003 report, 26 ombudsmen offices were identified.² In 2007, the National Taxpayer Advocate initiated a new survey of federal external ombudsmen and identified 18 additional offices either created after the 2003 report or not identified in that report.³ The National Taxpayer Advocate sent a second round of surveys to both the newly identified offices and the ones discussed in the 2003 report.

Within the federal government, the ombudsman function is expanding. Legislation and individual agency initiatives serve to create new ombudsmen offices every year. The survey of federal external ombudsmen attempts to categorize the differences and similarities between the offices and to recognize strengths and weaknesses in the various shapes that these offices take. It also examines whether ombuds offices would be strengthened by the creation of a Federal Agency External Ombudsman Act. One clear trend emerged: external ombudsmen exist in many structures, sizes, authorities, and scopes, with minimal uniformity between offices.

² Lubbers, Jeffrey, *Independent Advocacy Agencies Within Agencies: A Survey of Federal Agency External Ombudsmen* (June 2003). The 26 previously identified offices include the National Taxpayer Advocate. While the Environmental Protection Agency Superfund Ombudsmen have 10 regional offices and one head office, for the purpose of this report the office is counted once.

³ See Appendices 1, 2, and 3, *infra*.

OVERVIEW OF OMBUDSMAN FUNCTION

Ombudsmen operate in many forms and encompass varying duties throughout the federal government. Some, such as the National Taxpayer Advocate⁴ and the Small Business Administration National Ombudsman for Regulatory Enforcement Fairness, exist as a result of congressional action.⁵ Others are established by agency initiative, including the Food and Drug Administration Center for Drug Evaluation and Research Ombudsman and the Office of International Affairs and Trade Relations Ombudsman.

ABA Ombudsmen Categories⁶

The American Bar Association (ABA) recognizes four types of ombudsmen: legislative, executive, organizational, and advocate. Organizational ombudsmen are not represented in the results of the Ombudsmen Survey as they are not external, that is, they serve a constituency internal to the organization whereas external ombudsmen serve a specific public population. A legislative ombudsman, in the context of federal external ombudsmen, results from an act of Congress and receives complaints from the public. Legislative ombudsmen may also advocate for change to agency policy or procedure. Executive ombudsmen, in the context of federal external ombudsmen, receive complaints from the public and may function to hold an agency or program accountable or to work jointly with the agency to improve specific programs. Advocate ombudsmen work on behalf of a specific population and may investigate complaints from that population in order to recommend proper remedies.

Ombudsmen from all three categories, and those who fit in more than one category, participated in the Ombudsmen Survey. The Survey also reached out to several ombudsmen who, at first glance, appeared to fall into the category of executive external ombudsmen. All five of these ombudsmen fall under the purview of the Department of Energy and serve as Technology Transfer Ombudsmen at various national laboratories. However, the technology transfer ombudsmen are employees of private companies and operate under federal contracts. One of these ombudsmen, from the Argonne National Laboratory, responded to the National Taxpayer Advocate's survey by providing a section of the federal contract establishing the ombudsman. The main purpose of the contract is to work with contractors to facilitate the transfer of intellectual property to private U.S. companies. The ombudsman function exists to investigate complaints from the companies about the transfer procedures and decisions.

⁴ IRC § 7803.

⁵ 15 U.S.C. § 657.

⁶ American Bar Association, *Standards for the Establishment and Operation of Ombuds Offices* (Feb. 9, 2004), available at <http://meetings.abanet.org/webupload/commupload/AL322500/newsletterpubs/115.pdf> (last visited Dec. 15, 2009).

Ombudsmen Standards

American Bar Association Standards⁷

In 2004, the ABA refined its original list of 12 ombudsman essentials into its Standards for the Establishment and Operation of Ombudsman Offices.⁸ Three principles form the core of the new standards: independence, impartiality, and confidentiality. The ABA finds these principles essential to the effective operation of an ombudsman office. Lacking the core principles opens an ombudsman to potential control by the organization within which he or she serves.

The ABA standards require an ombudsman to be independent in his or her “structure, function, and appearance.” No one subject to the ombudsman’s jurisdiction should limit the performance of the ombudsman’s duties or remove the ombudsman for retaliatory purposes. This protection should extend to indirect controls such as the ombudsman’s legal counsel or budget and resources.

An ombudsman must be free from bias or conflicts of interest while performing his or her duties to maintain impartiality. At a minimum, the ombudsman should be independent from management or other administrative obligations or functions because the more an ombudsman must rely on his or her parent organization, the more difficult it is to operate impartially. The ombudsman must have the ability to gather information in a manner that will allow him or her to impartially consider the interests of all parties within his or her jurisdiction.

Confidentiality must extend to all communications with and documents created by the ombudsman in the performance of his or her obligations. The ability to keep information confidential will promote disclosure to the ombudsman, elicit candid discussions, and reduce the chance for retaliation against complainants. Reliance on existing confidentiality protections in state or federal legislation may not be sufficient. The agency or legislation creating the ombudsman office should adopt written policies that provide for the highest level of confidentiality allowed by law.

In addition, the ABA also suggests limiting an ombudsman’s authority to ensure the accomplishment of the three core characteristics. An ombudsman should not change or directly compel the change of any “law, policy, or administrative/managerial decision.”⁹ The ombudsman, in order to avoid due process problems, should keep his or her review separate from, and not allow it to substitute for, existing administrative or judicial proceedings. Similarly, the ombudsman should not act as an appellate forum for formal proceedings and should avoid issues that are “pending in a legal forum.” External ombudsman should

⁷ *Id.*

⁸ American Bar Association, *Standards for the Establishment and Operation of Ombuds Offices*, 54 Admin. L. Rev. 535 (2002).

⁹ American Bar Association, *Standards for the Establishment and Operation of Ombuds Offices* (Feb. 9, 2004), at <http://meetings.abanet.org/webupload/commupload/AL322500/newsletterpubs/115.pdf> (last visited Dec. 15, 2009). However, an ombudsman may advocate for change where his or her investigation has determined a need for such change. *Id.* at 14.

not address labor or employment law issues, or issues subject to any collective bargaining agreement without specific authorization from the employer.

*International Ombudsman Association Standards*¹⁰

The International Ombudsman Association (IOA) promotes the IOA Standards of Practice, a set of guidelines designed to ensure an ombudsman office operates according to the IOA's Code of Ethics. The 2005 merger of the University and College Ombudsman Association with The Ombudsman Association established the IOA, which now claims to be the largest organizational ombudsman association in the world with over 500 members.¹¹

The IOA espouses four ethical principles as essential for maintaining the integrity of the ombudsman profession:

- Independence;
- Neutrality and impartiality;
- Confidentiality; and
- Informality.

An ombudsman office should be independent from other organizational entities. The ombudsman should hold no other position within the organization and should have the authority to select his or her staff and access “all information and all individuals in the organization as permitted by law.”

The ombudsman should also strive for “impartiality, fairness, and objectivity” while fulfilling his or her obligations. The ombudsman may achieve impartiality by remaining independent from normal staff structures and creating reporting requirements that allow him or her to communicate directly with the highest levels of the organization.

The IOA also imposes a duty upon the ombudsman to hold all communications confidential. Even if waived by the party dealing with the ombudsman, the privilege belongs to the ombudsman and the IOA provides the ombudsman with the sole discretion whether to disclose the information. The only exception to this duty of confidentiality is where there is an “imminent risk of serious harm” and “there is no other reasonable option.” The IOA also recommends that the ombudsman resist testifying in any formal proceeding outside of the organization, even if given permission to do so.

The final standard of the IOA is informality. The ombudsman should avoid making binding decisions and should instead operate as “an informal and off-the-record resource” to supplement any existing formal procedures.

¹⁰ IOA, *IOA Standards of Practice*, at http://www.ombudsassociation.org/standards/StdPractice_1-07.pdf (last visited Dec. 15, 2009).

¹¹ See <http://www.ombudsassociation.org/about/> (last visited Dec. 15, 2009).

*United States Ombudsman Association Standards*¹²

Founded in 1977, the United States Ombudsman Association (USOA) membership focuses on public sector ombuds.¹³ The USOA provides educational opportunities for ombuds and advocates for the creation of ombudsmen offices in local, state, and federal governments.¹⁴ Although founded in the U.S., the USOA membership is comprised of ombudsmen offices from many nations. Its membership is open to any incumbent public sector ombudsman as well as the staff of any public sector ombuds office.¹⁵

In addition to providing a guide on the ABA Standards for the Establishment and Operations of Ombuds Offices, the USOA has adopted its own set of Governmental Ombudsman Standards. The USOA divides its standards into the four categories of independence, impartiality, confidentiality, and credible review process.

The addition of “credible review process” as a standard for ombuds offices differs from the standards of the ABA and the IOA. Encompassed by the credible review process standard, the USOA includes tenets that address the transparency of the ombuds office, the qualifications of an ombuds, and the jurisdiction of the office of the ombuds. The USOA standards require the ombuds to offer reports to his or her appointing authority as well as the public to provide transparency in the activities of the office, regardless of whether the office is required by law or administrative convention to issue reports. Additionally, the credible review process standard calls for an ombuds to have the power to thoroughly investigate matters before his or her office by having clearly established authorities, including the ability to requisition relevant documents. Many of the tenets under the credible review process appear to fall into the categories of independence and impartiality addressed by both the ABA and the IOA standards.

Coalition of Federal Ombudsman

The Coalition of Federal Ombudsmen (CFO), which organized in 1996, encompasses both internal and external federal ombudsmen.¹⁶ Members of the CFO meet to discuss their roles as ombuds in the federal government, exchanging ideas and experiences in an effort to help learn about the ombudsman function.¹⁷ Although it has not adopted its own official set of standards, the CFO promotes the belief that ombudsmen should possess the characteristics of independence, impartiality, and confidentiality.

¹² USOA, *Governmental Ombudsman Standards*, at http://www.usombudsman.org/documents/PDF/References/USOA_STANDARDS.pdf (last visited Dec. 15, 2009).

¹³ USOA, *About Us*, at http://www.usombudsman.org/en/About_Us/about_usoa.cfm (last visited Dec. 15, 2009).

¹⁴ *Id.*

¹⁵ USOA, *Membership Categories*, at http://www.usombudsman.org/en/membership/member_categories.cfm (last visited Dec. 15, 2009).

¹⁶ CFO, *Historical Perspective*, at <http://ombudsman.ed.gov/federalombuds/history.html> (last visited Dec. 15, 2009).

¹⁷ *Id.*

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Common to all three ombudsmen organizations are the ABA's three core characteristics. This report will focus on an analysis of federal external ombudsman under the ABA definitions.

TAS Survey Results

In August 2007, TAS sent updated questionnaires to 23 of the 26¹⁸ ombudsman offices that were identified in our 2003 survey as well as the 18 newly identified federal external ombudsmen.¹⁹ Of the 41 surveys, 19 agencies responded (including TAS). Sixteen of the responses were from ombudsmen who were identified in the original survey.

Independence

Responses to TAS's recent survey indicate that most external ombudsmen lack the independence the ABA standards recommend, in structure, function and appearance.²⁰ One office, the Ombudsman for the Federal Reserve Board of Governors, indicated that she has access to independent counsel. The remaining participants rely on agency counsel and only a few have mechanisms in place to screen appointed counsel from issues within the ombudsman's jurisdiction. In the 2002 Annual Report to Congress, the National Taxpayer Advocate discussed the inherent conflict of interest created by requiring ombudsmen to rely on agency counsel.²¹ Agency counsel, which reports to and is evaluated by the parent organization, may need to provide advice to the ombuds that is "directly contrary" to the advice of counsel representing the parent organization.²² Such conflict directly impairs the successful performance of the ombudsman's duties.

The ABA standards recommend that no person subject to the jurisdiction of the ombuds have the authority to eliminate the office, remove the ombuds, or change the budget of the office.²³ Although most survey participants indicated they were not subject to removal by a superior within his or her jurisdiction, their responses to other questions indicate otherwise. At least 12 of the participating ombudsmen report directly to their parent agency, often to the same officer or group who appointed the ombudsman and may have the

¹⁸ Two ombudsmen, the Agency for Toxic Substances and Disease Registry (ASTFR), and the Environmental Protection Agency Hazardous Waste Ombudsman, contacted in the 2003 Report could not be located for the current report. The pages were removed from the ASTFR's and EPA's websites and only cached information is available. The previous contact information for the offices is not valid. The ombudsman for the former Immigration and Naturalization Service appears to have been removed in a governmental reorganization. One survey to the NASA Ombudsman for Acquisition was returned as undeliverable. Calls and emails to this office went unanswered.

¹⁹ One survey to the Ombudsman for the Department of the Interior Insular Affairs, Mariana Islands was returned as undeliverable. Calls and emails to this office went unanswered.

²⁰ ABA, *Standards for the Establishment and Operation of Ombuds Offices* (Feb. 9, 2004), at <http://meetings.abanet.org/webupload/commupload/AL322500/newsletterpubs/115.pdf> (last visited Dec. 15, 2009).

²¹ National Taxpayer Advocate 2002 Annual Report to Congress 202.

²² *Id.*

²³ ABA, *Standards for the Establishment and Operation of Ombuds Offices* (Feb. 9, 2004), at <http://meetings.abanet.org/webupload/commupload/AL322500/newsletterpubs/115.pdf> (last visited Dec. 15, 2009).

authority to remove the ombudsman.²⁴ One participant, the Ombudsman for the Center for Biologics Evaluation and Research, of the Food and Drug Administration (FDA), noted that it was theoretically possible for someone within her jurisdiction to remove her from office. The ability of the agency to appoint its own ombudsman may allow the agency to appoint only those employees deferential to the agency's interests.²⁵ These controls over the position of the ombudsman undermine the ombudsman's independence from his or her parent organization.

Five participants reported that they do not have independent budgets,²⁶ one office did not respond to that question,²⁷ and another office did not have an answer at the time of the survey.²⁸ The ABA guidelines state that parent organization control over the ombudsman's budget provides indirect control over the staffing and daily operations of the ombudsman office itself. Requiring the ombudsman to rely on a parent organization for funding severely restricts both functional and apparent independence. When the parent organization retains budgetary control over the ombudsman office, it creates the potential for the organization to simply eliminate the ombudsman with a budgetary change.

Impartiality

Five of the participating ombudsmen explicitly stated that they have administrative obligations in addition to their ombudsman functions.²⁹ More than 40 percent of the participants indicated they do not have the authority to obtain documents or information.³⁰ Reliance on the parent organization for the tools necessary to advocate effectively creates a conflict of interest that may require the ombuds office to give greater weight to the interests of its parent organization over the interests of its beneficiaries.

The degree to which the ombudsman provides for transparency in his or her day-to-day activities contributes towards his or her perceived impartiality. Although the majority of

²⁴ Agency on Aging; FDA Office of the Ombudsman; Small Business Administration National Ombudsman for Regulatory Enforcement Fairness; FDA Center for Drug Evaluation and Research; FDA Center for Devices and Radiological Health; FDA Center for Biologics Evaluation and Research; Comptroller of the Currency; Department of Education Federal Student Aid Ombudsman; Agency for International Development, Acquisition and Assistance Ombudsman; Tennessee Valley Authority; Federal Reserve Board of Governors Ombudsman; National Credit Union Administration.

²⁵ At least one office, the National Taxpayer Advocate, has statutory procedures that protect against this type of hazard. The National Taxpayer Advocate must not have served as an employee of the IRS for two years previous to appointment and cannot serve as an IRS employee for five years after leaving office. IRC §7803(c)(1)(B)(iv). Another office, the Agency on Aging, has an employment restriction prohibiting the appointment of anyone to the Director position who has worked for a long-term care facility; a corporation that then owned or operated a long-term care facility; or an association of long-term care facilities. The Director and his or her family must also be free from conflicts of interest and the Director must not have an ownership interest in a long-term care facility or be entitled to any compensation from a long-term care facility. Older Americans Act of 1965, Pub. L. No. 109-365, § 201(d)(2)(B) (2006).

²⁶ Federal Reserve Board of Governors; National Science Foundation Acquisition Ombudsman; Agency for International Development, Acquisition and Assistance Ombudsman; FDA Center for Devices and Radiological Health; FDA Center for Drug Evaluation and Research.

²⁷ National Credit Union Administration.

²⁸ Office of International Affairs and Trade Relations.

²⁹ Office of International Affairs and Trade Relations; National Science Foundation Acquisition Ombudsman; National Credit Union Administration; FDA Center for Drug Evaluation and Research; FDA Center for Biologics Evaluation and Research.

³⁰ Agency on Aging; Citizenship and Immigration Services; Energy Employees Occupational Illness Compensation; FDA Center for Biologics Evaluation and Research; FDA Center for Devices and Radiological Health; FDA Office of Ombudsman; Federal Deposit Insurance Corporation; Federal Reserve Board of Governors.

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the participants provide information to the public via their websites or other publications, only ten of the 19 ombudsmen have specific reporting requirements³¹ and only four of those report directly to Congress.³² Reports from the offices that do not report to Congress are generally available to the public only from the ombudsman's website, which is usually a single page within the agency's site, or through publications distributed by the parent organization. Dependence on the parent agency to publicize the work of the ombudsman can create the perception that the ombudsman and the agency are the same entity, frustrating the mission of the office of the ombuds.

Confidentiality

Almost all of the participating ombuds attempt to provide maximum confidentiality protections, and post written policies explaining this commitment on their websites. Most cite the Privacy Act,³³ the Administrative Dispute Resolution Act,³⁴ and FOIA³⁵ as the basis for their policies. However, most participants indicate that they rely on their parent agencies to handle FOIA requests or court orders requiring disclosure. Reliance on the parent organization requires the ombudsman to share customer information with the same organization with which the customer has an issue. No ombudsman mentioned abuse of this privilege, but the possibility of abuse, coupled with the apparent lack of confidentiality, may dissuade customers from utilizing the ombudsman's services.

Legislative Proposal

A Federal Agency Ombudsman Act would provide much-needed protection and structure to federal ombudsmen offices. If an act existed, Congress would not have to start from scratch each time it created an ombuds office and it would guide agencies as they create their own such offices. In October 2009, the Department of Commerce sought comments on a proposal for an Ombudsman Pilot Program in the United States Patent and Trademark Office.³⁶ The proposal demonstrated the need for agencies to have clear guidance when creating ombuds offices in order to avoid simply instituting what amounts to a complaints department with no actual authority, independence, impartiality protections, or confidentiality shields.

³¹ Citizenship and Immigration Service; National Taxpayer Advocate; Energy Employees Occupational Illness Compensation; Small Business Administration National Ombudsman for Regulatory Enforcement Fairness; Agency on Aging; Department of Education Federal Student Aid Ombudsman; FDA Center for Drug Evaluation and Research; Federal Deposit Insurance Corporation; National Science Foundation; Office of International Affairs and Trade Relations.

³² Citizenship and Immigration Service; National Taxpayer Advocate; Energy Employees Occupational Illness Compensation; Small Business Administration National Ombudsman for Regulatory Enforcement Fairness. Since sending the survey, a new legislative ombudsman, the Freedom of Information Act (FOIA) Ombudsman was created by the Open Government Act of 2007 with the requirement to recommend policy changes to Congress and the President relating to FOIA. The position remained unfilled until Sept. 2009 when Miriam Nisbet was selected. See <http://www.archives.gov/ogis/nisbet-bio.html> (last visited Dec. 17, 2009).

³³ 5 U.S.C.A. § 552a.

³⁴ 5 U.S.C.A. § 571 et seq.

³⁵ 5 U.S.C.A. § 552.

³⁶ Federal Register, Vol. 74, No. 206, Oct. 27, 2009 at 55212.

Congress could use the Inspector General Act of 1978 as a guide in crafting legislation.³⁷ The Act 1978 created Inspector General Offices in all government agencies and detailed their general responsibilities, authorities, and duties. Additionally, it detailed specific duties and requirements for individual offices such as the Inspector General of the Department of Defense and the Federal Deposit Insurance Corporation. A similar format would work for a Federal Agency External Ombudsman Act. However, rather than automatically create ombudsmen in every agency, a Federal Agency External Ombudsman Act would be a template for all future ombudsman offices created either by legislation or administrative actions. Each new office would be required to have all the elements of the Act and then Congress or the initiating agency would specifically detail the purpose and scope of the work of the new ombudsman. As such, any new ombuds office would be guaranteed, at a minimum, the protections of the Act.

Several legislative ombudsmen, such as the National Taxpayer Advocate and the Citizenship and Immigration Ombudsman, enjoy protections carefully crafted by Congress to allow an ombuds office to function with independence, impartiality, and confidentiality.³⁸ Such offices and their enabling legislation provide a blueprint for a Federal Agency External Ombudsman Act as Congress can examine what has and has not worked in these offices over their tenures to strengthen and protect the role of ombudsmen.

CONCLUSION

Ombudsmen functions and authorities vary widely from agency to agency. Many lack the protections they need to fully function as impartial, independent, and confidential offices. Between legislatively created and agency-initiated ombudsmen, the differences in protections are even greater. Lacking the basic protections necessary to the ombudsman function, ombudsmen offices have the potential to be removed, unfunded, and viewed as extensions of the parent organizations.

Such concerns are not merely academic. The case of an ombudsman defying its parent agency and then fading into obscurity is familiar to anyone who has studied the case of the EPA Hazardous Waste Ombudsman. The previous report indentified the Hazardous Waste Ombudsman as a federal external ombudsman.³⁹ At this time, all information regarding the Hazardous Waste Ombudsman has been removed from the EPA website and only cached information remains available. The contact information for the ombudsman is not valid. The office suffered problems prior to the 2002 resignation of Robert Martin, who had served in the position since 1992.⁴⁰ Martin charges that during this period, the agency transferred his position to the simple function of answering phones, moved his office into the EPA Office of the Inspector General, and at one point changed the locks on his office

³⁷ Inspector General Act of 1978, Pub. L. No. 95-452, 92 Stat. 1101 (1978).

³⁸ See IRC § 7803 and 6 U.S.C. § 272.

³⁹ Lubbers, Jeffrey, *Independent Advocacy Agencies Within Agencies: A Survey of Federal Agency External Ombudsmen* 18 (June 2003).

⁴⁰ Edward Walsh, *EPA's Quiet Man in the Middle*, Wash. Post, Dec. 8, 1998.

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and took his computer and files while he was traveling on official EPA business.⁴¹ Shortly thereafter, Martin resigned, and the function of the Hazardous Waste Ombudsman moved to Region 4 of the EPA Office of the Inspector General.⁴² No information about the current status of the Hazardous Waste Ombudsman is available on the EPA website.⁴³

Similar situations could arise in other ombudsmen offices that are not protected by legislation or given independent budgets to guarantee their continued existence. The essential requirement for an ombudsman to be protected from such agency discretion points to the potential need for an ombudsman act. An ombudsman act could provide a basic roadmap for any agency or Congress when creating a new ombudsman office, ensuring the new office has characteristics of a successful ombuds office.

An overarching ombudsman act, providing for minimum standards in the creation of any federal external ombudsman, could relieve many concerns that arise when an ombudsman office is closely tied to a parent agency. Not only would an act serve to protect ombudsmen, but it could also work to assure customers that the ombudsman is independent from the parent agency and operates without interference, thus strengthening the ombudsman role.

⁴¹ FPMI's FedNews OnLine, April 25, 2002.

⁴² *Recent Developments in the EPA Office of the Ombudsman, Hearing before the H. Comm. on Energy and Commerce Subcomm. on Environment and Hazardous Materials*, 107th Cong., 2nd Sess. (July 16, 2002) (Testimony of Mark Bialek, Counsel to the EPA Inspector General).

⁴³ See <http://epa.gov/> (last visited Dec. 15, 2009).

Appendix 1: Participating Ombudsman Offices

Administration on Aging

Long Term Care Ombudsman
Sue Wheaton, Program Director
www.aoa.gov

Agency for International Development

Acquisition and Assistance Ombudsman
Jean Horton, Ombudsman
www.usaid.gov/business/ombudsman.html

Office of the Comptroller of the Currency

Samuel P. Golden, Ombudsman
www.occ.treas.gov

Consumer Product Safety Commission

Patricia Bittner, Ombudsman
www.cpsc.gov/BUSINFO/ombud.html

Customs and Border Protection

Office of International Affairs and Trade Relations
Michael C. Mullen, Acting Ombudsman

Department of Education

Federal Student Aid Office
Debra Wiley, Ombudsman
www.ombudsman.ed.gov

Federal Deposit Insurance Corporation

Cottrell Webster, Ombudsman
www.fdic.gov/regulations/resources/ombudsman/index.html

Federal Reserve Board of Governors

Margaret McCloskey Shanks, Ombudsman
www.federalreserve.gov/generalinfo/ombudsman/default.htm

Food and Drug Administration

Office of the Ombudsman
Laurie Lenkel, Ombudsman
www.fda.gov/oc/ombudsman/homepage.htm

Food and Drug Administration

Center for Biologics Evaluation and Research
Sheryl Lard-Whiteford, PhD, Ombudsman
www.fda.gov/cber/inside/ombudsman.htm

Food and Drug Administration

Center for Devices and Radiological Health
Les Weinstein, Ombudsman
www.fda.gov/cdrh/ombudsman/index.html

Food and Drug Administration

Center for Drug Evaluation and Research
Virginia L. Behr, Ombudsman
www.fda.gov/cder/ombud

Department of Homeland Security

Citizenship and Immigration Services Ombudsman
Michael Dougherty, Ombudsman
www.dhs.gov/cisombudsman

Department of Labor

Energy Employees Occupational Illness Compensation Program
Malcolm Nelson, Ombudsman
www.dol.gov/eeombd

National Credit Union Association

Michael McNeill, Ombudsman
www.ncua.gov/ombudsman

National Science Foundation

Acquisition Ombudsman Office of Budget, Finance, and Award Management
Joanna Rom, Deputy Director of BFA
www.nsf.gov/bfa/dcca/ombuds.jsp

Small Business Administration

National Ombudsman
Esther H. Vassar, Ombudsman
www.sba.gov/ombudsman

Taxpayer Advocate Service

National Taxpayer Advocate
Nina Olson, National Taxpayer Advocate
<http://www.irs.gov/advocate/>

Tennessee Valley Authority

Peyton T. Hairston, Ombudsman
www.tva.gov

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Appendix 2: Non-Participating Offices*

American Red Cross

Beverly Babers, Ombudsman
http://www.redcross.org/services/governance/0,1082,0_358_00.html

Census Bureau

Small Business Ombudsman
Eli Serrano
<http://www.census.gov/eos/www/osbonew/osbo.html>

Department of Defense

Acquisition Ombudsman
Susan Hildner, Ombudsman
<http://www.acq.osd.mil/dpap/paic/DoDOmbudsman.htm>

Environmental Protection Agency

Asbestos and Small Business Ombudsman
Angela Suber, Acting Ombudsman
<http://www.epa.gov/sbo/>

Environmental Protection Agency

Superfund Public Liaison
Victoria Van Roden
<http://www.epa.gov/reg3hwmd/super/ombudsman.htm>

Federal Aviation Administration

Aviation Noise Ombudsman
Patricia Fliesenbahn, Ombudsman
http://www.faa.gov/about/office_org/headquarters_offices/aep/aircraft_noise

Food and Drug Administration

Center for Veterinary Medicine
Marcia Larkins, Ombudsman
<http://www.fda.gov/cvm/ombudsman1.htm>

Department of Health and Human Services

Medicare Beneficiary Ombudsman
Daniel Shriner
<http://www.cms.hhs.gov/center/ombudsman.asp>

Department of Housing and Urban Development

Competition Advocate and Task/Delivery Order Ombudsman
Jacquelyn Harris, Ombudsman
<http://www.hud.gov/offices/cpo/about/ombuds.cfm>

Department of the Interior

Office of Insular Affairs
James Benedetto, Ombudsman
<http://www.doi.gov/oia/Firstpginfo/Ombudsman.htm>

Department of Justice

Victim's Rights Ombudsman
Marie A. O'Rourke, Ombudsman
<http://www.usdoj.gov/usao/eousa/vr/index.html>

National Aeronautics and Space Administration

Ombudsman for Acquisition
James A Balinskas, Ombudsman
<http://ec.msfc.nasa.gov/hq/library/Omb.html>

National Oceanic and Atmospheric Administration

Fisheries Ombudsman
Sebastian O'Kelly, Ombudsman

Securities and Exchange Commission

Small Business Ombudsman
<http://www.sec.gov/info/smallbus/reachsec.htm>

Small Business Administration

Office of Advocacy
Thomas Sullivan, Chief Counsel
<http://www.sba.gov/advo/>

Department of the Treasury

Office of Thrift Supervision
Frederick R. Casteel, Ombudsman
<http://www.ots.treas.gov/pagehtml.cfm?catnumber=82>

Veterans Affairs

Board of Veterans' Appeals Ombudsman
Kevin Taugher, Ombudsman
<http://www.va.gov/vbs/bva/contactbva.htm>

* Information is current as of September 30, 2008, based on publicly available information.

Appendix 3: Department of Energy Technology Transfer Ombudsmen

- National Energy Technology**
Donald Bonk
<http://www.netl.doe.gov/business/ombudsman.html>
- Argonne National Laboratory**
William Schertz
<http://www.anl.gov/techtransfer/Ombudsman.html>
- Brookhaven National Laboratory**
Technology Transfer Ombudsman
http://www.bnl.gov/techxfer/SponsoredResearch/ombudsman_role.asp
- Savannah River Site**
Procurement Ombudsman
<http://www.srs.gov/general/busiops/PMMD/ombudsman.htm>
- Y-12 National Security Complex**
Willie J. Wilson
<http://www.y12.doe.gov/business/techtransfer/ombudsman.php>

Appendix 4: Federal Ombudsman Survey Questions

FEDERAL OMBUDSMAN SURVEY 2007

1. Please identify the name of your office and the agency (or department), if any, that it resides in.
2. Please give the name of the ombudsman in (or other head of) your office.
3. Does your office have a website? If so, please provide the internet address.
4. Please provide the date that your office was established and any name change that has occurred since its establishment.
 - a. If you are providing an update, please list any name change that has occurred since the 2002 survey.
5. Who established your office, for example, the Congress or an agency official?
6. What is the statutory or regulatory basis for your office? Please give the citation to the Public Law, C.F.R., Federal Register, internal delegation, or other administrative document that created your office.
7. Was there any particular reason your office was established? In other words, was there a triggering event, report, or controversy that led to the creation of your office, or was it established due to a sense of general need?
8. Please provide the “statement of mission” for your office, if any.
 - a. If you are providing an update, has the mission statement of your office changed at all since the previous survey? If so, please provide the new statement.
9. Please describe the role of your office in addressing customer complaints.
 - a. What is your “jurisdiction?”
 - b. Does the ombudsman have the direct authority to resolve problems?
 - c. Does the ombudsman primarily mediate or otherwise facilitate resolution between the customer and other components of your department/agency?
 - d. Does your office play other resolution roles?
 - e. If you are providing an update, please address any changes that have occurred in the role of your office in addressing customer complaints.
10. To whom does the ombudsman report within the agency (or elsewhere)?
 - a. If you are providing an update, has the reporting structure in your office changed since the 2002 survey?

11. What, if anything (laws, rules, guidelines, norms, customs, reporting mechanisms, etc), assures that your office is independent?
 - a. If you are providing an update, have the mechanisms for assuring that your office is independent changed since the previous report?
12. Please describe the staffing and structure of your office.
 - a. What is the employment status of the Ombudsman (or head of your office)? (Presidential appointee, career SES, non-Career SES, GS-15, other?). Note if the Ombudsman serves for a fixed term.
 - b. Are there specific job qualifications for the position of Ombudsman? Are these qualifications statutory or administrative?
 - c. Can anyone subject to the Ombudsman's jurisdiction discipline or remove the ombudsman or his or staff?
 - d. How may employees report to the Ombudsman? If possible, provide a breakdown between clerical and professional employees.
 - e. Does the Ombudsman have independent legal counsel, or must he/she rely on counsel provided by the agency? Are there any safeguards to protect contacts with counsel?
 - f. What is the overall budget of the Ombudsman's office for the most recent fiscal year? Please identify the fiscal year.
13. Please describe the level of confidentiality between the Ombudsman Office, the customer, and the department/agency. Does the ombudsman have the authority to prevent disclosure outside his or her office of information provided in confidence by the customer? Can he/she be required under any circumstances to share the communications/info with the agency or anyone else? If you can share examples of this being tested, please do so.
 - a. If you are providing an update, please describe any changes in the level of confidentiality between the Ombudsman Office, the customer, and the agency/department.
14. If there is some level of confidentiality, what is that based on (legislation, departmental policy, other)? Please be as specific as you can.
15. Does your office have standard procedures or any plan for legal action for handling information disclosure requests?
16. Does your office have specific authority to seek and obtain documents and information? If so please describe what that authority is based on?
17. Does your office have specific reporting requirements (annual or periodic reports, etc.)? If so, to whom?

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18. Please describe the extent of Congressional or other oversight? Is there a specific Congressional committee or other outside group that monitors your activities in an active way?
 - a. If you are providing an update, please describe any changes in the extent of Congressional or other oversight of your office since the 2002 survey.
19. Is the ombudsman a member of any local or national ombudsman organizations? If so, please provide the names of the organizations.
20. How does your office publicize its service to your target customers?
21. How do your intended customers or beneficiaries contact your office and lodge a case? Please provide the contact information or a web address where this information is located.
22. Are employees of your agency/department (not of the Ombudsman's office) informed of the services your office provides? If so, please describe how you provide this information.
23. Is there a process within your agency whereby issues your office addresses are routed to you? Please describe this process.
24. Is there any other information about the structure or function of your office that is not covered in this survey or in the 2002 Report that you think should be included?
25. Please provide the name and phone number of a contact person for follow up if there are any further questions about your office's activities.
26. Please attach or mail any documents that may aid in the understanding the above answers (annual reports, copies of regulatory documents, delegations, legislative histories, etc.).

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Ombudsmen

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Appendix 5

Office	Ombudsman	Website	Date Est.	Established By	Basis for	Reason for Establishment	Authority to Resolve Problems	Primary Role	Reports to
Administration on Aging Long-Term Care Ombudsman	Sue Wheaton (program director)	www.aoa.gov	1978	Congress	Public Law 89-73	Poor conditions in long-term care facilities	Yes	Mediate/ systemic advocacy	Director, Office of consumer Choice and Protection
Agency for International Development, Acquisition and Assistance Ombudsman	Ms. Jean Horton	www.usaid.gov/business/ombudsman.html	1994	Congress	Federal Acquisition Streamlining Act of 1994 USC 2304c	No Response	Yes	Mediation, consultant	Agency Procurement Exec
Citizenship and Immigration Services Ombudsman, Dep. Homeland Security	Michael Dougherty	www.dhs.gov/cisombudsman	2003	Congress	Homeland Security Act 2002 sec 452; 6 USC 272	Assist USCIS focus on immigration system	No	Mediator/ systemic recommendations	Deputy Secretary of Homeland Security
Department of Education, Federal Student Aid Office	Debra Wiley	www.ombudsman.ed.gov	1999	Congress	1998 amendments to Higher Education Act of 1965	Informal assistance for problems w/ student aid	No	Mediation/ facilitation, reporting	Federal Student Aid Chief Operating Officer
Energy Employees Occupational Illness Compensation program, Department of Labor	Malcolm D. Nelson	www.dol.gov/eeombd	2004	Congress	Sec. 3686 of FY 2005 Def. Authorization Act	To improve new payment program	No	Advise/mediate/report	Deputy Secretary
FDA, Center for biologics Evaluation and Research	Sheryl Lard-Whiteford, PhD	www.fda.gov/cber/inside/ombudsman.htm	1993	CBER center director	Managerial Action	To assist FDA Ombudsman	No	Mediator	FDA director
FDA, Center for Devices and Radiological Health, Food, and Drug Administration	Les Weinstein	www.fda.gov/cdrh/ombudsman/index.html	1999	Director of agency	N/A	In "spirit of legislation"	Sometimes	Mediator/ other resolution roles	Director of CDRH
FDA, Center for Drug Evaluation and Research (CDER)	Virginia L. Behr	www.fda.gov/cder/ombud	1995	Agency official	MaPP, CFR p3, 21 CFR 312.48,314.103	Unknown	Yes	Mediator/ formal dispute resolution/ advisor	Center director
FDA, Office of Ombudsman	Laurie Lenkel	www.fda.gov/oc/ombudsman/homepage.htm	1990	Commissioner of FDA	Managerial Action	Response to "generic drug scandal"	No response	Mediation/ liaison takes over when specific ombuds fails	No response
Federal Deposit Insurance Corporation	Cottrell Webster	www.fdic.gov/regulations/resources/ombudsman/index.html	1994	Congress	Community Development and Regulatory Imp. Act of 1994, sec 309(d)	Banking difficulties and closures of early 90's	No	Mediate/ advocate for change	FDIC COO, who reports to Chairman

Office information continued on next page (as spread)

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Independence Protections	Employment Status	Removal by Person in Reporting Chain?	Independent Counsel Access	Independent Budget	Confidentiality Protections?	Confidentiality Basis	Information Disclosure Protection	Authority to Obtain Documents	Reporting Requirements	Congressional Oversight
OAA and state implementations	Program director: Govt. employee	Yes, head of state agency sponsoring program	State provides "in various modes"	Yes	Yes	OAA sec 712(d)	None	Not at federal level, OAA has access provisions	Yes, states to AoA community	None
Statute 10 us 2304c(f)	Appointed by head of agency	Yes, procurement executive	No: Agency Counsel	None	Yes	Policy, Position Description, IOA standards of practice	No response	Policy, position description	None	None
Statute 452(a)	Appointed by Secretary of Homeland Security	No	No: Homeland Security General Counsel	Yes	Share only to extent necessary to resolve problem	Privacy Act	DHS Privacy Act and DHS Privacy office guidelines	No, relies on voluntary submissions from customers	Annually to Congress	Yes, several committees
Organizationally distinct b/c of statute	Appointed by Department COO	Only by COO or higher	No: Agency Counsel	Yes	Yes, to extent of law	ABA, USOA standards, CFO	Policy manual	Implicitly through COO	Yes, to COO	None
Statute	SES position, on detail from Benefit review board	No	No: Agency Counsel is screened though	Yes	All Govt. privileges/protections	PA	Forwarded to agency	No, Agency powers only	Congress, yearly	Yes, several committees
Norms of informal dispute resolution	Career Govt. employee w/ other responsibilities	Theoretically	No	Depends on other duties	Statutory	FOIA, PA, ADRA	FOIA guidelines	No	None	None
None	Career Govt. employee	No	No: Agency Counsel	None	Limited: must disclose for litigation in which FDA is a party, request by Congress	Ombudsman principles	Agency procedures	No	Annual to public/agency voluntarily	None
No response	Career Govt. employee w/ other responsibilities	Not known	No: Agency Counsel	None: uses agency	Confidential but for Congressional/ court order	Pledge of confidentiality	Division of Information disclosure policy	Yes, to most documents	Yes, CDER newsletter	None
No response	Career Govt. employee w/ other responsibilities	No response	No: Agency Counsel	Yes	Norms of informal dispute resolution	No response	No response	No	Unknown	None
None	Open-ended at will	Yes	No: Agency Counsel	No response	Some, except for court orders, OIG investigation, and potentially agency management	The Ombudsman Association standards,	Rejects informal requests, formal requests handled by legal division (which rejected the "ombudsman privilege")	No	Monthly to COO, contributes to several Congressional reports	None

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Office	Ombudsman	Website	Date Est.	Established By	Basis for	Reason for Establishment	Authority to Resolve Problems	Primary Role	Reports to
Federal Reserve Board of Governors	Margaret McCloskey Shanks	www.federalreserve.gov/generalinfo/ombudsman/default.htm	1995	Congress	309(d) of Riegle Act, 12 USC 4806(d)	Riegle Act attempted to reduce administrative requirements	No	Mediator	Board of Governors of Federal Reserve
National Credit Union Association Ombudsman	Michael McNeill	www.ncua.gov/ombudsman	1994	Congress	Community Development and Regulatory Imp. Act of 1994	No Response	No	Mediate	Commission
NSF Acquisition Ombudsman in Office of Budget, Finance, and Award Management	Ms. Joanna Rom, Deputy director of BFA	www.nsf.gov/bfa/dcca/ombuds.jsp	2003	NSF Director	Federal Acquisition Regulation §16.505	FAR 16.505	No	Mediator	NSF Director/senior NSF management personnel
Office of the Comptroller of the Currency	Samuel P. Golden	www.occ.treas.gov	1993	Administrative action	Administrative Authority	To provide independent means for banks to settle disagreements	Independent supervisory appeals process, may stay appealable agency decision subject to override by comptroller	Arbitration, some mediation	Comptroller of Currency
Small Business Administration	Esther H. Vassar	www.sba.gov/ombudsman	1996	Congress	SBREFA 15 USC 631 et seq	White House conference on small business	No: may request high level review	Facilitates review of unfair enforcement	SBA administrator; congress
Tennessee Valley Authority	Peyton T. Hairston	www.tva.gov	2007	Chief Executive Officer	Delegation	To provide independent channel for reporting concerns from stakeholders (not customers)	No	Mediate	Chief Executive Officer
Trade Relations, Office of International Affairs and Trade Relations w/in Customs and Border Protection	(temp) Michael C. Mullen	none (contributes to www.cbp.gov)	1990	Customs and Border Protection	Administrative Authority	Avoid creation by legislation	No	Mediator	Agency commissioner/Asst. Commissioner
Consumer Product Safety Commission	Patricia Bittner	www.cpsc.gov/BUSINFO/ombud.html	Unknown	Unknown	No response	Enhance relations between small businesses and agency	Doesn't appear to	Liaison/consultation	Unknown

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Independence Protections	Employment Status	Removal by Person in Reporting Chain?	Independent Counsel Access	Independent Budget	Confidentiality Protections?	Confidentiality Basis	Information Disclosure Protection	Authority to Obtain Documents	Reporting Requirements	Congressional Oversight
Riegle Act	Appointed by Board from long-serving Reserve employees, has other duties	Not likely	Ombuds is attorney, obtains independent advice when necessary	Budget depends on other duties	Except in unusual circumstances, yes	Riegle	Standard. procedure	Voluntary compliance	Voluntary briefs to Board and staff	Congressional overview of Board, some indirect contact with Representatives.
None	Govt. employee w/ other responsibilities	Probably	No	None	Yes	None	None	No response	Informally to commission	None
NSF manual	Additional duty for senior NSF official	Not likely	No	None	Unclear, can't compromise party outside Govt. involvement	NSF manual	NSF FOIA official	Yes	Inform NSF Director of issues and actions	None
12 USC 48 requires intra-agency appellate process/ agency policy	Appointed by Comptroller	NA	No	Yes	No response	OCC bulletin 2002-9	FOIA guidelines	No response	Voluntary, annual	None
SBREFA	Non-career SES Govt. employee	No response	No: Agency Counsel	Yes	Yes	SBREFA	Privacy Act, General counsel policy statements	Yes, SBREFA, FACA	Annually to Congress; SBA administrator	Yes, Small Business Committees
Not independent	Appointed indefinitely	No	No	No response	Must share info as needed with CEA and Board	None	FOIA guidelines	TVA expected to comply with requests (based on CEO authority)	Voluntary to CEO	None
No response	Career Govt. employee w/ other responsibilities	Unknown	Unknown	Unknown	Unknown	Unknown	SOPs	Yes	Yes, internally	None
Unknown	No response	No response	No response	No response	No response	No response	No response	No response	No response	No response

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